DOCUMENT RESUME

ED 185 947 HE 012 667

TITLE	Changes Needed in the Tax Laws Governing the Exclusion for Scholarships and Fellowships and the Deduction of Job Related Educational Expenses. Report by the Comptroller General of the United States.
INSTITUTION	Comptroller General of the U.S., Washington, D.C.
REPORT NO	GGD-78-72
PUB DATE	31 Oct 78
NOTE	118p.
EDRS PRICE	MF01/PC05 Plus Postage.
DESCRIPTORS	College Students; Court Litigation; Discriminatory Legislation; Disqualification; Eligibility; Equal Protection; Federal Regulation; *Fellowships; Financial Aid Applicants; Higher Education; *Income; *Justice; *Laws; Legal Problems; *Scholarships; *Taxes
IDENTIFIERS	Department of the Treasury; *Internal Revenue Service

ABSTRACT

Problems caused by the tax law and Department of the Treasury regulations related to the income exclusion for scholarships and fellowships and the deduction of job-related educational expenses were studied. Legislative changes that may reduce the amount of controversy generated by these two sections of the Internal Revenue Code are recommended. A detailed examination was conducted of 257 randomly selected cases pending review in the Appellate Division of the Internal Revenue Service and 281 court cases already decided. The tax rules and Treasury regulations were found to be confusing and difficult to apply. Determination of the tax status of educational grants and expenses depends upon the making of precise factual and legal distinctions in fact situations that are essentially comparable. The result is that taxpayers similarly situated are treated in a dissimilar manner. The General Accounting Office suggests a solution designed to: (1) simplify the tax rules applicable to educational grants and deductions, and (2) accord approximately equal tax treatment for persons in similar situations. (SW)

****
* Reproductions supplied by EDRS are the best that can be made *
* from the original document. *
****

ED185947

REPORT BY THE

Comptroller General

OF THE UNITED STATES

Changes Needed In The Tax Laws Governing The Exclusion For Scholarships And Fellowships And The Deduction Of Job Related Educational Expenses

GAO found the applicable tax rules of section 117 of the Internal Revenue Code, and section 1.162-5 of the Treasury Regulations to be confusing and difficult to apply in an even-handed manner. Determination of the tax status of educational grants and expenses depends upon the making of precise factual and legal distinctions in fact situations which are essentially comparable. The result is that taxpayers similarly situated are treated in a dissimilar manner.

The burden of interpreting these tax-law rules through the administrative and judicial settlement process is placed on a relatively small group of taxpayers: teachers, graduate students, and professionals who seek further education as a means of job enhancement.

GAO suggests a solution designed to (1) simplify the tax rules applicable to educational grants and deductions and (2) accord approximately equal tax treatment for persons in similar situations.

U S DEPARTMENT OF HEALTH.
EDUCATION & WELFARE
NATIONAL INSTITUTE OF
EDUCATION

THIS DOCUMENT HAS BEEN REPRODUCED EXACTLY AS RECEIVED FROM THE PERSON OR ORGANIZATION ORIGINATING IT POINTS OF VIEW OR OPINIONS STATED DO NOT NECESSARILY REPRESENT OFFICIAL NATIONAL INSTITUTE OF EDUCATION POSITION OR POLICY

UNITED STATES GENERAL ACCOUNTING OFFICE

HE 012 667

GGD-78-72
OCTOBER 31, 1978

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-137762

To the Chairman and Vice Chairman
Joint Committee on Taxation
Congress of the United States

This report, one in a series in response to your Committee's request that we examine ways to simplify the tax laws, addresses problems caused by the tax law and Treasury regulations related to the income exclusion for scholarships and fellowships and the deduction of job-related educational expenses. We recommend legislative changes which should reduce the amount of controversy generated by these two sections of the Internal Revenue Code.

As this report went to press, the Congress passed the Revenue Act of 1978. One part of the act added section 164 to the Internal Revenue Code to exclude from an employee's income educational assistance provided by an employer under a qualified program. Section 164 does not appear to affect the conclusions and recommendations in our report.

As arranged with your Committee, unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from its date. At that time, we will send copies to interested parties and make copies available to others upon request.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE JOINT
COMMITTEE ON TAXATION
CONGRESS OF THE UNITED
STATES

CHANGES NEEDED IN THE TAX LAWS GOVERNING THE EXCLUSION FOR SCHOLARSHIPS AND FELLOWSHIPS AND THE DEDUCTION OF JOB-RELATED EDUCATIONAL EXPENSES

DIGEST

During the last several years there has been a significant increase in the number of taxpayers contesting tax deficiencies determined by the Internal Revenue Service (IRS). The growth in the level of tax controversies has occurred at all stages of the administrative and judicial process, placing an increasing administrative burden on IRS and the courts. (See app. III.)

A high-level tax controversy poses a threat to our voluntary self-assessment tax system. IRS audit resources are limited. When tax rules are ambiguous or are perceived to be unfair, it is often to the taxpayers' advantage to resolve debatable items in their own favor. If audited and a deficiency proposed, the financial outlay required to dispute the item either through administrative channels or by litigation can be relatively low. Taxpayers do not have to pay proposed deficiencies in advance and can litigate many cases in the Tax Court without having to engage an attorney.

It is to the Government's advantage to reduce the level of taxpayer-IRS controversy. GAO discusses in this report how and why two related areas--exclusion of scholarships and fellowships from taxation and educational expense deductions--have been a principal cause of controversy and recommends changes to the Internal Revenue Code that should reduce the amount of controversy.

APPLICABLE CODE SECTIONS AND REGULATIONS DIFFICULT TO UNDERSTAND

Section 117 of the Internal Revenue Code, pertaining to the exclusion of scholarships

Tear Sheet. Upon removal, the report cover date should be noted hereon.

and fellowships, and Treasury regulations section 1.162-5, pertaining to the deduction of job-related educational expenses, are difficult to understand and sometimes confusing. As a practical matter, it is virtually impossible for IRS or the courts to apply the many tax computation rules of these two provisions in an even-handed manner because the rules make taxability turn upon innumerable precise factual determinations not relevant to considerations of ability to pay. The rules are focused more on the niceties of refining the definition of net taxable income than on according equal treatment to taxpayers similarly situated.

The result is that taxpayers who protest deficiencies based on disallowance of section 117 exclusion or regulations section 1.162-5 deduction are often propelled to pursue their cases through the administrative appeals process and through litigation quite as much by a sense of personal injustice as by a wish to minimize taxes.

GAO based its findings and conclusions on a detailed examination of 257 randomly selected cases pending in the Appellate Division of IRS for review and 281 decided court cases. GAO determined that the difference in the tax treatment of degree and nondegree students under section 117 of the Code, in particular the exemption of compensation for part-time employment received by degree students only, has created discontinuities which do not reflect differences in ability to pay.

Treasury regulations under section 117 have attempted to lend definiteness to the statute by removing from the scope of the exclusion payments that are compensation received by an employee and bargained-for compensation where no formal employment relationship exists. The United States Supreme Court in Bingler v. Johnson, 394 U.S. 741 (1969) sustained the regulations provision which applies this "quid pro quo" criterion to amounts received by both degree and nondegree students.

Although courts have consistently upheld the regulations position that the section 117 exclusion does not cover compensation in any amount, regardless of the degree status of the taxpayer, taxpayers have continued to litigate the issue. What is needed is a flat statutory rule stating that all compensatory and on-the-job trainee-stipends are taxable.

The statutory authority for deducting job-related educational expenses is section 162 of the Internal Revenue Code. It allows a deduction for "all ordinary and necessary" business expenses paid or incurred during the taxable year in carrying on a trade or business.

Treasury regulations have applied this statutory standard to:

--Allow as a business expense, deduction of the cost of education undertaken to maintain existing earning capacity.

--Disallow as a capital expense, or combined personal-capital expense, the cost of education undertaken to enhance existing earning capacity or to create new earning capacity.

As a practical matter, it is virtually impossible to apply these regulations criteria in an even-handed manner.

The courts, confronted with a large volume of educational tax litigation which is trivial and time consuming, have expressed impatience with the legal uncertainties created by section 117 and regulations section 1.162-5. Judges frequently have recommended that section 117 be amended to clarify the tax status of educational grants where there is present the element of compensation to some extent. Judges have also criticized the bias of the educational expense deduction regulations in favor of teachers and professors.

Chapter 2 discusses in detail GAO's analysis of section 117 and regulations section 1.162-5 and of the cases upon which GAO bases its conclusions and recommendations.

CHARACTERISTICS OF TAXPAYERS INVOLVED IN THE CONTROVERSIES

GAO found that, typically, the section 117 cases have concerned resident physicians and graduate teaching fellows who seek to exclude from their income compensation received for caring for hospitalized patients, for teaching undergraduate college students, or for doing research which inures to the benefit of the grantor.

Typically, the regulations section 1.162-5 cases have concerned persons employed as teachers, or in business, or government who seek to deduct expenses incurred for graduate-level education related to their jobs.

There is no significant difference in occupational grouping between taxpayers who have litigated their tax disputes through to a final decision and those presently involved in the administrative settlement process. Thus, the proliferation of legal precedent does not appear to be resolving the interpretative problems encountered by taxpayers in these occupational groups.

Teachers predominate in controversies involving the exclusion of scholarship and fellowship grants received by degree students as well as in controversies based upon disallowance of the deduction for job-related educational expenses. Full-time graduate students, who work as part-time instructors or teaching assistants in the graduate departments where they are enrolled, are second after teachers in contesting proposed deficiencies under the degree student issue category. Government employees are third after teachers in contesting proposed deficiencies based on the disallowance of job-related educational expenses. Licensed medical doctors employed in hospitals as residents or interns predominate in cases involving the exclusion of grants received by nondegree students.

The income range of taxpayers who contest deficiencies based upon disallowance of an exclusion for scholarship or fellowship grants, and upon disallowance of a deduction for educational expenses, is not large. Seventy-five percent of all taxpayers in the sample of Appellate Division cases had adjusted gross income of less than $9,900. Fifty percent had taxable income of $8,745 or less, while 67 percent of all taxpayers in the sample were in a marginal tax bracket of 20 percent or less.

Detailed information regarding the economic characteristics of these groups of taxpayers are discussed in chapter 3.

RECOMMENDATIONS

In chapter 5, GAO recommends that section 117 be amended and that a new educational expense deduction section be added to the Code.

Regarding section 117, GAO's recommended amendment does the following.

--Treats degree and nondegree students in the same way for tax purposes.

--Includes all scholarship and fellowship grants in gross income unless the grant meets all of the statutory requirements for exclusion. That is, an educational grant which does not qualify for exclusion under the amended section 117 is includible in gross income as a gift, or as a prize or award.

--Sets explicit statutory requirements which an excludible grant must meet. These requirements pertain to (1) the use to which the grant funds may be put, (2) the method of selection of the grantee, (3) the economic relationship between the grantee and the grantor, and (4) the tax status of the grantor.

--Requires the grant funds to be used for study or research at a facultied school or university with an established curriculum and regularly enrolled student body. An educational grant for independent study in libraries, museums, or travel in foreign countries would not qualify for exclusion, whether or not the grantor is an exempt educational organization or other qualified grantor. Fulbright fellowships and like grants would be fully taxable.

--Sets explicit statutory limits on the use of grant funds. They may be used to pay the costs of tuition, laboratory fees and like expenses, to pay the costs of meals and lodging in college or university housing facilities, to purchase required books and equipment, to pay the cost of travel incurred to locate at the school and to return home during vacation periods, and to purchase clerical help as for dissertation typing, referencing, and like assistance. Grant funds used for any other purpose would be taxable.

--Provides that the grantee may be selected on the basis of scholastic merit and ability, financial need, or on the basis of achievement in athletics, music, literature, art, science, community service, etc., provided the selection process is competitive and the standards for qualification are announced in advance.

--Removes educational grants from both the compensation and the gift categories. There can be no economic relationship between the grantor and grantee except that the grantee satisfy the requirements which are a condition for receiving the grant.

--Sets explicit statutory requirements with respect to the tax status of the grantor. The grantor must be a nonprofit educational, charitable, or religious organization, or a governmental agency.

Regarding regulations section 1.162-5, GAO recommends that it be withdrawn and replaced by a new section 192 and an amendment to section 62 which would do the following.

--Makes a qualified educational expense a deduction from gross income to reach adjusted gross income.

--Removes the distinction between job-related educational expenses which are capital or combined capital-personal in nature and those which are ordinary.

--Allows a business expense deduction, currently, for all ordinary and necessary job-related educational expenses. For this purpose an educational expense qualifies as an ordinary and necessary business expense if incurred "in connection with" the taxpayer's employment whether as an employee or self-employed person.

HOW GAO'S RECOMMENDATIONS CHANGE THE CURRENT LAW

GAO's proposals change the tax status of educational grants and expenses in the following respects:

--Treat as an expense reimbursement, educational grants given by an employer for job-related study by an employee. The grant is includible in gross income as compensation and deductible from gross income to reach adjusted gross income.

--Make the job-related educational expense deduction available to the taxpayer who finances his education out of taxable earnings whether or not he elects the standard deduction.

--Remove the bias of present law against taxpayers in the nonacademic professions who finance their own education in order to qualify for a promotion or for a new and better job in the same line of business.

--Include all nonqualified educational grants in gross income. An educational grant is not a gift or a prize or award.

It is a transfer of funds conditional on the taxpayer's performing the study or research described in the terms of the grant. Grant funds are earmarked for use in financing such study or research. A stipend is compensation for carrying out the study or research.

TREASURY COMMENTS

The Assistant Secretary of the Treasury for Tax Policy and the Commissioner of Internal Revenue jointly commented on GAO's recommendations. (See app. I.)

Treasury agreed that section 117 of the Code and section 1.162-5 of the Income Tax Regulations have been difficult to administer and have given rise to a significant amount of controversy.

Treasury does not believe, however, that the specific language of GAO's legislative recommendations would substantially simplify these areas or reduce the amount of controversy. Treasury suggests a number of alternatives that might be considered in lieu of GAO's legislative recommendations with respect to section 117. Treasury notes that these suggestions are intended to indicate a range of possible approaches for discussion and do not reflect the formal views of the Department as to whether revisions would ultimately be appropriate. Treasury does not suggest that any change be made to regulations section 1.162-5.

A detailed discussion of Treasury's comments and GAO's analysis of them appears on pages 73 to 82 of the report.

Contents

		Page
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Tax controversies involving educational grants and expenses	2
	Scope of report	8
2	TAX LAW RULES DIFFICULT TO ADMINISTER	10
	Exclusion from income of amounts received for study, research, or teaching	10
	Deduction of job-related educational expenses	25
3	CHARACTERISTICS OF TAXPAYERS	41
4	EVALUATION OF THE TAX LAW RULES AS AN AID TO EDUCATION	53
	Application of tax expenditure theory	53
	Examples of unequal treatment of taxpayers in like financial circumstances	55
	Conclusion	63
5	OVERALL CONCLUSIONS, RECOMMENDATIONS, AND TREASURY'S POSITION	65
	Conclusions	65
	Recommendations to the Congress	70
	Treasury comments and our evaluation	72
APPENDIX		
I	Letter dated July 21, 1978, from the Assistant Secretary for Tax Policy and Commissioner of Internal Revenue	82
II	Internal Revenue Service--Administrative Appeals Procedure	90
III	Increase in Contested Tax Deficiencies	93

APPENDIX Page

IV Method used to calculate a deficiency based upon disallowance of an income exclusion or itemized deduction 100

ABBREVIATIONS

GAO	General Accounting Office
IRS	Internal Revenue Service

CHAPTER 1

INTRODUCTION

This report, the first in a series, is designed to cover eight issue areas which are a principal source of taxpayer-Internal Revenue Service (IRS) controversy, both at the administrative level and in the courts. These eight issue areas are:

1. Exclusion of scholarships and fellowships.
2. Educational expense deductions.
3. Personal casualty loss deductions.
4. Unreported income.
5. Definition of taxable compensation.
6. Definition of trade or business.
7. Travel expense deductions.
8. Application of support test for children of divorced parents.

Our work, done at the request of the Joint Committee on Taxation, is a part of the larger effort by the Congress and the administration to simplify the Federal income tax laws and to improve the efficiency of the tax-conflict resolution process. By analyzing separately those tax issues which have been a principal cause of controversy during the last several years, we can identify the source of the continued contention and be in a position to recommend legislation or regulation changes which will at least narrow the area of taxpayer-IRS disagreement.

This report examines the principal legal and factual issues which are a source of controversy in cases arising out of proposed deficiencies or refund claims based upon disallowance of an exclusion for scholarship or fellowship grants or upon disallowance of a deduction for job-related educational expenses. For many years these two issues have contributed significantly to the level of contested tax cases at the administrative level and in the courts. We have attempted to determine why these two issues are a principal source of controversy and to describe the characteristics of taxpayers involved. Based upon our overall finding that the present rules do not accord approximately equal tax treatment for persons in similar circumstances, we suggest a legislative solution that will correct this situation.

Appendixes II and III provide a detailed discussion of the IRS administrative appeals procedure and of the overall increase in contested tax deficiencies.

A high level of tax controversy poses a real threat to the voluntary self-assessment system. Audit resources are limited. Where tax rules are ambiguous or are perceived to be unfair, it is to the advantage of taxpayers to resolve debatable items in their own favor. If audited and a deficiency is proposed, the financial outlay required to dispute the item either through administrative channels or by litigation is relatively low. The taxpayer does not have to pay the proposed deficiency in advance and, under the new small tax cases procedure of the Tax Court, the case can be litigated without having to engage an attorney. Further, as administrative rules and judicial precedents proliferate, taxpayers come increasingly to perceive it to be to their advantage to carry their cases through litigation, despite the record of favorable Government wins in the courts. We have reached a point where the precedent generated by the formal administrative and judicial conflict-resolution process, instead of reducing the level of tax controversy, has itself become a contributing cause of controversy.

TAX CONTROVERSIES INVOLVING EDUCATIONAL GRANTS AND EXPENSES

Two of the most intractable of the issues which are a significant source of tax controversy arise out of the exclusion of amounts received for study, research, or teaching and the deduction of expenditures for job-related educational expenses. In general, section 117 of the Internal Revenue Code exempts from tax amounts received as a scholarship or fellowship grant at an educational institution. This exemption includes, in addition to the scholarship or fellowship grant, amounts covering expenses for incidental travel, research, clerical help, or equipment. For an individual who is not a candidate for a degree, the amount excludable is subject to dollar and time limitations and may not include compensation for incidental part-time employment in any amount. In addition, the grantor must satisfy specific statutory requirements where the grantee is a nondegree student.

In general, under Treasury regulations section 1.162-5, educational expenses are deductible if they qualify as ordinary and necessary business expenses. They are not deductible if considered personal or as an inseparable aggregate of personal and capital expenditures.

Controversies arising out of proposed deficiencies based upon disallowance of an exclusion for scholarship and fellowship grants or of a deduction for job-related educational expenses constitute a significant percentage of total cases in controversy at all stages of the administrative and judicial process. Cases arising under these two issues also have been the subject of innumerable revenue rulings.

At the district level during the fiscal year ended June 30, 1976, 2,679 (6.8 percent) of the 39,146 individual income tax cases closed by district conferees were classified under the principal issue of the exclusion of a scholarship or fellowship grant (1,120 cases) or of a deduction for job-related educational expenses (1,559 cases). Most of these 2,679 educational tax controversies arose out of proposed deficiencies based upon disallowance of a deduction. In deciding the 2,679 educational tax cases, the conferees usually sustained the examiner's findings when the issue involved a grant exclusion. This was not true for the educational expense deduction cases. A possible explanation for this difference may be that IRS examiners and taxpayers alike have considerable difficulty in understanding regulations section 1.162-5. The tables below summarize the settlement record of the educational grant and expense cases. 1/

Claims for refund cases

Issue	Sustained in full No.	Sustained in full Percent	Sustained in part No.	Sustained in part Percent	Disagreed in full No.	Disagreed in full Percent
Educational grants	123	74.1	25	15.1	18	10.8
Educational expenses	41	56.2	13	17.8	19	26.0

1/Available data was not sufficiently precise to classify 27 of the 2,679 cases.

Nonclaim cases

Issue	Sustained in full		Sustained in part		Disagreed in full	
	No.	Percent	No.	Percent	No.	Percent
Educational grants	744	78.5	84	8.9	120	12.7
Educational expenses	694	47.4	499	34.1	272	18.6

At the Appellate Division level for fiscal year 1976, 19,496 nondocketed tax cases, corporate and individual, were closed by appellate conferees or by the filing of a petition. Of this total, approximately 3.47 percent, representing 676 cases, arose out of deficiencies based upon disallowance of an exclusion for scholarship or fellowship grants or upon disallowance of a deduction for job-related educational expenses. These 676 cases are distributed 20.41 percent (138 cases) to issues involving degree candidates; 43.49 percent (294 cases) to issues involving nondegree candidates; and 36.09 percent (244 cases) to the educational expense issue. The table summarizes the settlement record of the 676 nondocketed educational grants and expense cases disposed of by settlement or by the filing of a petition at the Appellate Division level, fiscal year 1976.

Nondocketed cases closed by Appellate Division based upon deficiencies proposed by examining agent

Issue	Sustained in full		Sustained in part (note a)		Disagreed in full	
	No.	Percent	No.	Percent	No.	Percent
Educational grants	297	68.75	83	19.21	52	12.04
Educational expenses	122	50.00	103	42.21	19	7.79

a/The terminology "modified, no mutual concessions" and "modified, mutual concessions" is used by the Appellate Division settlement record. These terms accord approximately with the term "sustained in part" used by the District Conference settlement record.

The evidence is that taxpayers fare less well on the settlement of educational tax issues at the Appellate Conference level than at the District Conference level--but not by much. More than 70 percent of all docketed receipts received by the Appellate Division from the District Director's Office have not taken advantage of the Appellate Nondocketed Conference opportunity.

Whether taxpayers elect to settle cases at the District or the Appellate level, IRS settlement procedures tend to favor closing unagreed cases by settlement as soon as possible where the issues are primarily factual in nature and are nonrecurring with respect to the taxpayer for later years. This explains why the percentage of cases settled in favor of the taxpayer decreases as one moves through successive stages of the administrative appeals process. It also explains the high percentage of Government wins in cases litigated through to a final decision.

Once a case has been docketed, the Office of the Chief Counsel of IRS participates in the settlement negotiations. The table below sets forth the number and percent of docketed work units (two or more related cases) classified under one of the educational tax categories settled at the IRS national office level for fiscal years 1974 through 1976. 1/

1/Settlement can be made on the basis of an assessment of litigating hazards at all stages of the administrative settlement process, although the rules differ at each level. The District Conferee is bound by the IRS position on legal issues but can weigh the merits of factual contentions and has authority to settle cases involving proposed deficiencies of less than $2,500 for a single year on the basis of litigating hazards. The Appellate Conferee has authority to settle legal as well as factual issues on the basis of litigating hazards. Controversies classified by IRS as raising a "prime issue" present a special case and are not considered here since the educational tax issues are not classified by IRS as "prime issue" cases.

Number and percent of two or more related cases (docketed work units) disposed of by settlement - educational tax cases

	FY 1974		FY 1975		FY 1976	
	No.	Percent	No.	Percent	No.	Percent
Educational Grants						
Tax Court (excluding small tax cases)	37	78.72	39	75.0	30	81.25
Small tax cases	92	61.97	103	56.07	92	58.57
District Court, Court of Claims	1	50.0	1	33.33	0	0
Educational Expenses						
Tax Court (excluding small tax cases)	43	86.0	42	82.35	27	84.38
Small tax cases	100	75.76	97	80.83	113	68.90
District Court, Court of Claims	0	0	1	33.33	1	33.33

The following table summarizes the settlement record of docketed cases classified under one of the Uniform Issue List educational tax categories.

Settlement Record of Docketed Work Units

	Sustained in full		Sustained in part		Disagreed in full	
Issue	No.	Percent	No.	Percent	No.	Percent
Educational grants	158	40.00	127	32.15	110	27.85
Educational expenses	112	26.42	218	51.41	94	22.17

Thus, three-fourths of all docketed educational grants and expense cases settled at the national office level for fiscal years 1974 through 1976 were sustained in full or in part.

The percentage of Government wins, all courts, in educational tax cases is significantly higher than for all cases. (See table 1.4 in app. III.)

Settlement Record of Docketed Work Units

Court	FY 1974		FY 1975		FY 1976	
	No.	Percent	No.	Percent	No.	Percent
			Educational Grants			
Tax Court (excluding small tax cases)	10	100.00	11	78.57	9	100.00
Small tax cases	53	89.93	60	83.33	54	88.52
District Court, Court of Claims	1	100.00	1	50.00	3	100.00
			Educational Expenses			
Tax Court (excluding small tax cases)	7	100.00	8	88.89	4	80.00
Small tax cases	29	90.63	16	69.57	37	72.55
District Court, Court of Claims	0	0	1	50.00	2	100.00

This indicates that the IRS administrative settlement process has done an effective job of selecting out, in advance of trial, all but the most intractable cases. It also would appear, however, that the impressive record of Government wins is not effective to deter taxpayers from contesting deficiencies based upon disallowance of an exclusion for educational grants or of a deduction for educational expenses. In short, the courts do not appear able to write laws which can resolve the many ambiguities of section 117 and regulations section 1.162-5.

SCOPE OF REPORT

This report examines the principal legal and factual issues which are a source of controversy under section 117 and regulations section 1.162-5 and the characteristics of taxpayers who contest deficiencies in these two issue areas. A study of 257 cases of taxpayers presently contesting deficiencies involving the exclusion of scholarship and fellowship awards and the deduction of educational expenses at the Appellate Division level 1/ and 281 educational award and expense cases decided during the period of July 1967 through June 1977 provides data appropriate to generate evidence on the characteristics of the taxpayers who contest these deficiencies. 2/ These taxpayers bear the major portion of the burden of resolving the ambiguities and uncertainties of section 117 and regulations section 1.162-5. This burden is shared, of course, by all taxpayers to the extent that cases involving these two issues consume a disproportionate amount of the scarce administrative and judicial resources available for tax-conflict resolution.

In chapter 2 the current law is described and data is provided on the legal and factual issues which are most frequently in dispute under section 117 and regulations section 1.162-5. Chapter 3 examines the characteristics of

---

1/These 257 cases represent a sample taken from a universe of 999 cases, broken down by region and principal issue. The sample size is sufficient to make estimates at a 95-percent confidence level.

2/These 281 cases represent 100 percent of the decided cases reported in the Uniform Issue List.

taxpayers who contest deficiencies in the educational award and expense area. Chapter 4 is an assessment of the use presently made of the income tax system to subsidize certain educational costs.

Chapter 5 sets forth our overall conclusions, recommendations on the issues, and Treasury's comments about them.

CHAPTER 2

TAX LAW RULES DIFFICULT TO ADMINISTER

In this chapter we examine the tax law rules governing the exclusion from income of amounts received for study, research, or teaching and the deduction of job-related educational expenses.

EXCLUSION FROM INCOME OF AMOUNTS RECEIVED FOR STUDY, RESEARCH, OR TEACHING

Prior to 1954, there was no specific statutory provision with respect to the exclusion or inclusion in gross income of scholarships or fellowships. Taxability was determined on the basis of whether the grant qualified as a gift--with the Internal Revenue Service reluctant to find the requisite donative intent. 1/ The Congress was dissatisfied with the case-by-case method of deciding the tax status of educational grants. 2/ It wanted to eliminate the subjective tests inherent in the gift theory. Section 117 was added to the 1954 Code in the expectation that it would provide a "clear-cut method" for distinguishing between taxable and nontaxable grants and to eliminate the "existing confusion as to whether such payments are to be treated as income or gifts." 3/ Section 117 has largely failed in its purpose, however, principally because it does not define what kinds of receipts qualify as scholarship or fellowship grants.

The structure of section 117 is confusing

Section 117 purports to provide exclusive rules for determining the tax status of scholarship and fellowship

---

1/I.T. 4056, 1951 C.B. 8.

2/"The basic ruling of the Internal Revenue Service which states that the amount of a grant or fellowship is includable in gross income unless it can be established to be a gift has not provided a clear-cut method of determining whether a grant is taxable." S. Rept. No. 1622, 83rd Cong., 2d Sess., 17 (1954).

3/H. Rept. No. 1337, 83rd Cong., 2d Sess., 16 (1954).

grants. 1/ Subsection (a) of section 117 is framed in the form of an exclusion from gross income for "any amount received * * * as a scholarship at an educational organization * * * or as a fellowship grant." Subsection (b) of section 117 imposes different limitations and exceptions on the broad exclusion of subsection (a) depending upon whether the recipient is a degree or a nondegree candidate.

This is a confusing way to structure a tax computation rule. A general rule of exclusion applicable to undefined amounts received by any taxpayer pursuing a program of study or research sweeps into the excludable income category all income not specifically excluded. As a result, the principal interpretative burden is placed upon exceptions to the general rule of exclusion. In the absence of a statutory definition of scholarship and fellowship, the exceptions to the general rule are more numerous than the cases which conform to the rule.

The legislative intent is not clear

While the legislative history of section 117 indicates that the Congress did not intend to enact a broad exclusion provision, it is unclear in other respects. 2/ The report of the House Ways and Means Committee, accompanying H.R. 8300, 83rd Cong., 2d Sess. (1954) states:

> "The bill provides that amounts received as scholarships or fellowships are excludable from gross income, but the exclusion is not to apply to (1) amounts received as payments for research or teaching services, and (2) in the case of individuals who are not candidates for degrees, amounts received as grants which in effect represent a continuing salary during a period while the recipient is on leave from his regular job. * * *" (H. Rept. No. 1337, 83rd Cong., 2d Sess., pp. 16-17 (1954).

1/Regulations section 1.117-1(a), second sentence.

2/See opinion of the District Court in Quast v. U.S., 293 F. Supp. 56, 61 (D. Minn., 1968), aff'd 428 F. 2d 750 (8th Cir., 1970), which refused to follow the decision of the Third Circuit Court of Appeals in Johnson v. Bingler, 396 F. 2d 258 (1968), rev'd 394 U.S. 741 (1969).

The House contemplated that the earned income portion of a grant received by either a degree or a nondegree candidate to support study or research be taxable--and that the gift or donated portion be excludable.

> "When the scholarships and fellowships are granted subject to the performance of teaching or research services, the exclusion is not to apply to that portion which represents payments which are in effect a wage or salary. The amount included will be determined by reference to the going rate of pay for similar services. This allocation of the amount of the grant between taxable and nontaxable portions represents more liberal treatment than is allowed under present practice. Present law taxes the grant in its entirety unless services required of the recipient are nominal." H. Rept. No. 1337, 83rd Cong., 2d Sess. 17 (1954). 1/

The Senate, however, intended the exclusion rule to cover compensation for teaching, research, or other services, but only if such

> "* * * teaching, research, or other services are required of all candidates for a particular degree (whether or not recipients of scholarship or fellowship grants) * * *." S. Rept. No. 1622, 83rd Cong., 2d Sess., 18 (1954). 2/

1/Generally, the courts have rejected taxpayers' attempts to allocate an amount received in support of study or research between taxable compensation and excludable fellowship grant. See Quast v. U.S., 428 F. 2d 750 (8th Cir., 1970), affirming 293 F. Supp. 56 (D. Minn., 1968).

2/In Dorothy Steinmetz, 343 F. Supp. 384 (D.C. Calif., 1972) the court characterized this language as "an exception to a limitation on an exclusion." (P. 385.) An example of the kind of compensatory payment covered by the exclusion rule is the value of tuition and work payments granted to students enrolled in a tuition-free college which requires all students to participate in a work program as an integral part of its educational philosophy. Rev. Rul. 64-54, 1964-1 (part 1) C.B. 81. A graduate teaching assistantship based strictly on financial need and not on services performed.

The question is: Did the Congress intend the exclusion to apply to any amount of personal service income received by a nondegree candidate? Taxpayers, in particular licensed medical doctors employed as residents or interns, have argued persistently that the section 117 exclusion covers compensation where the work experience results in educational benefit to the recipient. 1/ The courts have taken the position that the exclusion does not cover personal service income in any amount; it does cover a stipend received for on-the-site training in hospitals, diet kitchens, schools, and like institutions if the position of the trainee is that of student-observer, not trainee-worker. 2/

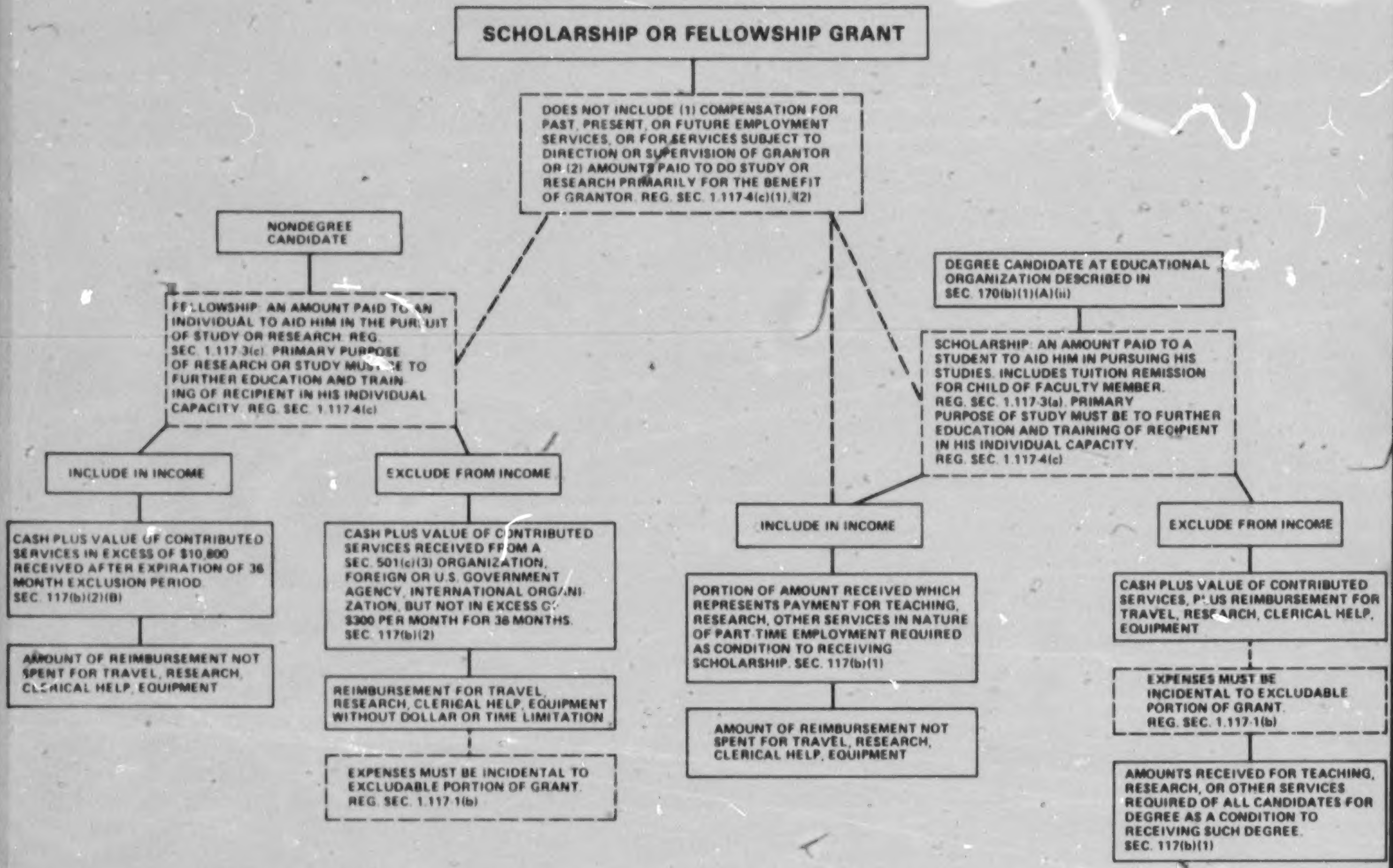
The regulations under section 117 write earned income concepts into the statutory exclusion

Treasury regulations under section 117 were adopted in 1956. 3/ These regulations are confusing and difficult to understand. They interpose between the general rule of income exclusion of subsection (a) and the specific statutory exceptions and limitations of subsection (b) earned income concepts remarkably like the gift criterion applied prior to enactment of section 117. It may be helpful in following an analysis of the statutory rules, as interpreted by the regulations, to use the chart set forth on the following page. Statutory criteria are enclosed in boxes drawn with solid lines; the related regulations criteria are enclosed in boxes drawn with dotted lines. Interrelationships among rules in the form of qualifications and exceptions are denoted by dotted connecting lines. The solid connecting lines denote criteria or tax computation rules which apply under the principal categories defined by the statute: degree versus nondegree student, income exclusion versus income inclusion.

1/See Marvin Flicker, et al 29 TCM 1115 (1970), which was a class action brought by 25 medical doctors enrolled in the Menninger School of Psychiatry and employed as residents in hospitals funded by the Veterans Administration.

2/Thomas P. Phillips, 57 T.C. 420 (1971), Acq.; Robert L. Shuff, 33 F. Supp. 807 (D.C. Va., 1971); Frederick A. Bieberdorf, 60 T.C. 114 (1973); Acq.

3/T.D. 6186.



SCHOLARSHIP OR FELLOWSHIP GRANT

DOES NOT INCLUDE (1) COMPENSATION FOR PAST, PRESENT, OR FUTURE EMPLOYMENT SERVICES, OR FOR SERVICES SUBJECT TO DIRECTION OR SUPERVISION OF GRANTOR OR (2) AMOUNTS PAID TO DO STUDY OR RESEARCH PRIMARILY FOR THE BENEFIT OF GRANTOR. REG. SEC. 1.117-4(c)(1), (2)

NONDEGREE CANDIDATE

FELLOWSHIP: AN AMOUNT PAID TO AN INDIVIDUAL TO AID HIM IN THE PURSUIT OF STUDY OR RESEARCH. REG. SEC. 1.117-3(c). PRIMARY PURPOSE OF RESEARCH OR STUDY MUST BE TO FURTHER EDUCATION AND TRAINING OF RECIPIENT IN HIS INDIVIDUAL CAPACITY. REG. SEC. 1.117-4(c)

INCLUDE IN INCOME

CASH PLUS VALUE OF CONTRIBUTED SERVICES IN EXCESS OF $10,800 RECEIVED AFTER EXPIRATION OF 36 MONTH EXCLUSION PERIOD. SEC. 117(b)(2)(B)

AMOUNT OF REIMBURSEMENT NOT SPENT FOR TRAVEL, RESEARCH, CLERICAL HELP, EQUIPMENT

EXCLUDE FROM INCOME

CASH PLUS VALUE OF CONTRIBUTED SERVICES RECEIVED FROM A SEC. 501(c)(3) ORGANIZATION, FOREIGN OR U.S. GOVERNMENT AGENCY, INTERNATIONAL ORGANIZATION, BUT NOT IN EXCESS OF $300 PER MONTH FOR 36 MONTHS. SEC. 117(b)(2)

REIMBURSEMENT FOR TRAVEL, RESEARCH, CLERICAL HELP, EQUIPMENT WITHOUT DOLLAR OR TIME LIMITATION

EXPENSES MUST BE INCIDENTAL TO EXCLUDABLE PORTION OF GRANT. REG. SEC. 1.117-1(b)

DEGREE CANDIDATE AT EDUCATIONAL ORGANIZATION DESCRIBED IN SEC. 170(b)(1)(A)(ii)

SCHOLARSHIP: AN AMOUNT PAID TO A STUDENT TO AID HIM IN PURSUING HIS STUDIES. INCLUDES TUITION REMISSION FOR CHILD OF FACULTY MEMBER. REG. SEC. 1.117-3(a). PRIMARY PURPOSE OF STUDY MUST BE TO FURTHER EDUCATION AND TRAINING OF RECIPIENT IN HIS INDIVIDUAL CAPACITY. REG. SEC. 1.117-4(c)

INCLUDE IN INCOME

PORTION OF AMOUNT RECEIVED WHICH REPRESENTS PAYMENT FOR TEACHING, RESEARCH, OTHER SERVICES IN NATURE OF PART-TIME EMPLOYMENT REQUIRED AS CONDITION TO RECEIVING SCHOLARSHIP. SEC. 117(b)(1)

AMOUNT OF REIMBURSEMENT NOT SPENT FOR TRAVEL, RESEARCH, CLERICAL HELP, EQUIPMENT

EXCLUDE FROM INCOME

CASH PLUS VALUE OF CONTRIBUTED SERVICES, PLUS REIMBURSEMENT FOR TRAVEL, RESEARCH, CLERICAL HELP, EQUIPMENT

EXPENSES MUST BE INCIDENTAL TO EXCLUDABLE PORTION OF GRANT. REG. SEC. 1.117-1(b)

AMOUNTS RECEIVED FOR TEACHING, RESEARCH, OR OTHER SERVICES REQUIRED OF ALL CANDIDATES FOR DEGREE AS A CONDITION TO RECEIVING SUCH DEGREE. SEC. 117(b)(1)

The "Quid Pro Quo" criterion is not a relevant income tax concept

Regulations section 1.117-4(c)(1), (2), summarized in the first box under the exclusion rule of section 117(a), is a nullifying condition precedent to application of the statutory limitations and exceptions of subsection (b). The regulation removes from the broad exclusion rule of subsection (a) payments that are compensation received by an employee from an employer (past, present, or future) and bargained-for compensation where no formal employment relationship exists. 1/ In particular, it specifically excepts from the scholarship and fellowship category "amounts paid to do study of research primarily for the benefit of grantor."

This is the famous *quid pro quo* criterion, followed by the Internal Revenue Service in administrative rulings and the trial of cases and upheld by the Supreme Court in *Bingler* v. *Johnson*. 2/ The court in Johnson interpreted the language of regulations section 1.117-4(c) to cover all "bargained-for payments, given only as a *quo* in return for the *quid* of services rendered--whether past, present, or future."

While importing the *quid pro quo* criterion into the statutory rule of exclusion lends definiteness to the term "scholarship and fellowship grants" (not defined in the statute) it does not establish a precise method for distinguishing between taxable and nontaxable grants. The *quid pro quo* criterion is essentially a compensation criterion, with overtones of concepts pertinent to the determination of personal income for national income accounting purposes.

1/One ingenious taxpayer, a resident medical doctor, tried to convert compensation received from a hospital into a fellowship by breaking his contract of residency which required that he work an additional year in an institution designated by the State Department of Mental Hygiene. The Tax Court was not persuaded by this ploy: "The fact that he reneged on this agreement and refused to take the one-year assignment he was given under the contract does not convert his 1970 salary payments into a fellowship grant." *Richard Lannon* 35 T.C.M. 1585, 1588 (1976).

2/394 U.S. 741 (1969), reversing 396 F. 2d 258 (3d Cir., 1968).

These concepts have no necessary relevance to the determination of income for tax purposes. The quid pro quo criterion implies that income for tax purposes consists of anything received in exchange or in return for something of commercial value. Conversely, amounts received in a transaction where there has been no exchange or creation of something of commercial value are not income for tax purposes. This, of course, is fallacious. Total personal income for tax purposes has no necessary relationship to national income and, indeed, can add up to more than national income, taking into account gains realized from the sale or exchange of existing assets, and items such as receipts from extortion, punitive damages, insiders' profits, gambling winnings, prizes, and awards--to name only a few forms of taxable income for which there is, strictly speaking, no quid pro quo and which are not reflected in national income.

The "quid pro quo" criterion applies to both degree and nondegree students

The quid pro quo criterion of regulations section 1.117-4(c) applies to both degree and nondegree students. This legal hurdle must be passed in order to reach the issue of whether the taxpayer qualifies as a degree or as a nondegree candidate. 1/ Section 117(b)(1) defines a degree candidate as an individual who is a candidate for a degree at

> "* * * an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried." 2/

This is one of the few provisions of section 117 which is so clearly stated that it has generated no litigation. A nondegree candidate is anyone who is pursuing a program of study, research, or training whether at an educational

---

1/Robert N. Worthington, 31 T.C.M. 447 (1972), affirmed 476 F. 2d 589 (10th Cir., 1973); David M. Brubakken, 67 T.C. 249 (1976); Morgan M. McCoy II, 34 T.C.M. 1435 (1975).

2/The quoted language is from section 170(b)(A)(ii) pertaining to the definition of educational organizations which qualify for the 50-percent limitation on charitable contributions deductions.

institution, in a public library, or at home. 1/ The statute does not distinguish between grants which are scholarships and grants which are fellowships, and the distinction, recognized in other circumstances between the two forms of educational grant, has no tax law significance. The regulations note this distinction by designating as a fellowship an amount received by a nondegree candidate 2/ and as a scholarship an amount received by a degree candidate. 3/

The primary purpose test of the regulations is not a workable rule

The same regulations section 1.117-4(c), which establishes the *quid pro quo* criterion, provides further, with respect to both nondegree and degree candidates, that an amount paid to an individual to enable him to pursue studies or research will qualify as an excludable scholarship or fellowship

> "* * * if the primary purpose of the research or studies is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph."

There are two problems with this regulations' provision: As a practical matter, in most situations, there does not exist a "primary purpose." Generally, a dual or mutual benefit is involved. 4/ Also, it is not clear whose purpose is to be regarded as "primary." In the case of a government grant or a grant from private industry, the purpose of the grantor may be to realize an end product in the

---

1/For example, a research grant to enable the recipient to travel, study, and consult others concerning his field of work qualifies as an excludable fellowship grant if no element of compensation is involved. Rev. Rul. 74-86, 1974, C.B. 36.

2/Regulations section 1.117-3(c).

3/Regulations section 1.117-3(a).

4/*Chander P. Bhalla*, 35 T.C. 13 (1960), Acq.

form of a report or patentable device. 1/ The purpose of the university which administers the grant or which is, itself, the grantor, may be to add to the stock of human knowledge. 2/ The purpose of the grantee, of course, is to further his own education and training and he, as the litigant, will always urge that it is his purpose which is the "primary" one. 3/

The regulations are circular in structure

The structure of regulations section 1.117-4(c) is circular and hence difficult to apply in differing factual circumstances. The quid pro quo limitations of subparagraphs

---

1/Gerald R. Faloona, 34 T.C.M. 265 (1975); Nicholas V. Findler, 35 T.C.M. 1602 (1976).

2/In Frederick A. Bieberdorf, 60 T.C. 124 (1973), Acq. an exclusion was allowed for a grant received by a licensed physician who participated in an N.I.H. funded program of graduate training which included some clinical work. The benefits were found to flow to the academic community as a whole rather than to the grantor specifically. In Revenue Ruling 75-280, 1975-2 C.B. 47 the Service issued guidelines for determining the taxability of amounts received by a graduate student, PhD candidate, for research and teaching services performed for a university which had contracted to carry out such teaching and research for the Atomic Energy Commission. In general, the amounts received are excludable provided the taxpayer does not perform services in excess of those required by all degree candidates. See also, Louis C. Vaccaro, 58 T.C. 721 (1972).

3/Medical interns, in particular, have tried to avoid the compensation limitation by arguing that the hospital where they are employed as residents has as its primary objective the teaching and training of interns and residents and that the treatment of patients is secondary to the teaching function. The courts have rejected this argument on the ground that the determinative question is not the purpose of the hospital but the purpose of the payment to the intern or resident. Parr v. U.S., 469 F. 2d 1156 (5th Cir., 1973); Eugene Hembree, 464 F. 2d 1262 (4th Cir., 1972); Irwin S. Anderson, 54 T.C. 1547 (1970); Bruce A. Woodling, 35 T.C.M. 1766 (1976).

(1) and (2) of regulations section 1.117-4(c) are an exception to the section 117(a) exclusion. However, they are phrased as an exception to the "enable-the-individual-to-pursue-his-own-studies-or-research" rule which, itself, is subject to the "primary purpose" reservation. And the "primary purpose" reservation restates the original quid pro quo limitation.

The convoluted structure of regulations section 1.117-4(c) is made evident if capital Roman letters are substituted for each of the criteria. Let A and B refer to the quid pro quo limitations of subparagraphs (1) and (2); C refer to the enable-the-individual-to-pursue-his-own-studies-or-research requirement; D refer to the primary purpose reservation. Making this substitution, the regulation reads: Do not exclude if A or B is true even though C is true. Exclude if C is true unless D is not true. If D is not true, this means that A or B is true.

The quid pro quo and "primary purpose" criteria have generated a disproportionate amount of tax controversy because they are difficult to understand and virtually impossible to apply in an even-handed manner. This fact has not gone unnoticed by courts presented with section 117 cases for decision. For example, Chief Judge Brown of the Fifth Court of Appeals expressed exasperation with the structure of the regulations in Parr v. U.S. 1/

> "We do not attempt to dictate a per se rule holding that all advanced medical personnel are employees and that all payments to them are subject to taxation. However, we sympathize with the District Court's lamentation that these facts, or facts nearly identical, have been litigated so often that one may wonder whether this is wise or what good it can do. * * * But hope springs eternal. And the heartbeat--the vital sign to doctors young and old--of hope is the question begging structure of the regulations: Payments made for the "primary purpose--to further the education and training of the recipient" are fellowship grants unless--and the unless is a big unless--the amount provided for such purpose represents compensation. (Note 4, supra). Which is to say, this is not the last word, only the latest." (p. 1159.)

1/469 F. 2d 1156 (1972).

The mechanical tests of the statute are easy to administer

Proceeding down the chart of these rules, we come next to the mechanical tests of the statute applicable to nondegree candidates only. The maximum amount that a nondegree candidate can exclude from gross income is $10,800 ($300 a month for 36 months, whether or not consecutive). The dollar limitation applies to the value of contributed services, such as housing accommodations, parking, laundry service, and insurance received by medical residents. It does not include any amount received as reimbursement for travel, research, clerical help, and equipment. Regulations section 1.117-1(b) imposes only one further requirement and that is that such reimbursed expenses must be incident to the excludable portion of the grant. 1/ The maximum exclusion is available only if the nondegree candidate receives at least $300 a month. These mechanical tests have not been a source of tax controversy.

The other statutory requirement applicable to nondegree candidates only is that the source of the fellowship must be a tax-exempt charitable, religious, educational, or other eleemosynary organization described in section 501(c)(3); a foreign government, an international organization, or foundation created pursuant to the Mutual Educational and Cultural Exchange Act of 1961; the Federal Government or a State or local government. These requirements also have not been a source of tax controversy.

In summary, a nondegree candidate can exclude from income a grant which meets the statutory source and dollar limitations, provided such grant does not constitute earned income. Amounts received in excess of the dollar limitation

---

1/The courts in sustaining deficiencies based upon disallowance of an exclusion for cash payments received by medical residents in some cases have ignored this distinction and have treated contributed services as excludable without regard to the dollar limitation and even though the cash payments are held taxable compensation. Michael D. Birnbaum, 30 T.C.M. 910 (1972). Strictly speaking if the stipend is taxable because section 117 does not apply, contributed services are taxable because section 119, relating to the exclusion of meals and lodging furnished for the convenience of the employer, does not apply. Steven M. Weinberg, 64 T.C. 771 (1975); Walter L. Peterson, 33 T.C.M. 1367 (1974).

or from a nonqualified source are includable in gross income whether or not they constituted earned income. 1/

1/Most of the decided cases involving these rules concern payments to medical interns and residents. Leonard T. Fielding, 57 T.C. 761 (1972); Jacob T. Moll, 57 T.C. 579 (1972); Arthur Calick, 31 T.C.M. 69 (1972); Larry R. Taylor, 31 T.C.M. 57 (1972); Frederick Fisher, 56 T.C. 1201 (1971); John M. Gullo, 30 T.C.M. 1434 (1971); Ernest G. Morre, Jr., 30 T.C.M. 1347 (1971); Brian T. Steinhaus, 30 T.C.M. 1157 (1971); Dee L. Fuller, 30 T.C.M. 1116 (1971); Michael D. Birnbaum, 30 T.C.M. 989 (1971), aff'd, 73-1 USTC par. 9378 (3rd Cir. 1973). William K. Rundell, 30 T.C.M. 177 (1971), aff'd, 455 F. 2d 639 (5th Cir. 1972), Emerson Emory, 30 T.C.M. 785 (1971); Tobin v. U.S., 323 F. Supp. 239 (S. D. Tex. 1971); Irwin S. Anderson, 54 T.C. 1547 (1970); Edward A. Ballerini, 29 T.C.M. 1595 (1970); Janis Dimants, Jr., 29 T.C.M. 1138 (1970); Austin M. Katz, 29 T.C.M. 511 (1969); Coggins v. U.S., 70-2 USTC par. 9687 (N.D. Tex. 1970); Kwass v. U.S., 319 F. Supp. 186 (E.D. Mich. 1970), Alyosius J. Proskey 51 T.C. 918 (1969); Jonathan M. Kagan, 28 T.C.M. 617 (1969). Parr v. U.S., 469 F. 2d 1156 (5th Cir. 1972), aff'g unrep. D.C. dec.; Hembree, Jr. v. U.S., 1262 (4th Cir. 1972), rev'g 28 AFTR 2d 71-5603 (D.C.S.C. 1971); Bayard L. Moffitt, 31 T.C.M. 1226 (1972); Richard F. Bergeron, 31 T.C.M. 1226 (1972); Emerson Emory, 32 T.C.M. 245 (1973) appeal dismissed; Robert S. Chancellor, T.C. Memo 1976-385; Esfandiar Kadivar, 32 T.C.M. 427 (1973); Enrique Kaufman, 32 T.C.M. 525 (1973); appeal dismissed. Paul R. Zehnder, 32 T.C.M. 1180 (1973) Dennis Dale Brenneise, 33 T.C.M. 1 (1974); Marvin L. Dietrich, 33 T.C.M. 66 (1974 aff'd 503 F. 2d 1379 (8th Cir. 1975)); George Weissfisch, 33 T.C.M. 391 (1974); John E. Hamacher, 33 T.C.M. 529 (1974); George M. Towns, 33 T.C.M. 632 (1974); Carl H. Naman, 33 T.C.M. 762 (1974); R. M. Nugent, Jr., 33 T.C.M. 690 (1974); Douglas R. Jacobson, 33 T.C.M. 762 (1974); Wesley E. McEntire, 33 T.C.M. 780 (1974); Geral W. Diet, 62 T.C. 578 (1974); Thomas A. Woods, 33 T.C.M. 861 (1974); Donald D. Fagelman, 33 T.C.M. 864; Byron L. Howard, Jr., 33 T.C.M. 869 (1974); Steven Weinberg, 64 T.C. 771 (1975); Narindra R. Thakkar, 34 T.C.M. 1262; Morgan McCoy, II 34 T.C.M. 1435 (1975); Jeremy Handleman, 34 T.C.M. 1437 (1975); Roger Mamy, 34 T.C.M. 1439 (1975); Sheldon A. E. Rosenthal, 63 T.C. 454 (1975); William S. Kammerer, 35 T.C.M. 30 (1976); James Ferro, 35 T.C.M. 388 (1976); Gloria B. Zimmermann, 35 T.C.M. 559 (1976); Charles J. Berger, 35 T.C.M. 752 (1976); David M. Brubakken, 67 T.C. 249 (1976); Richard A. Lannon, 35 T.C.M. 1585 (1976); Leonard J. Levine, 36 T.C.M. 264 (1977); Richard B. Zonderman 36 T.C.M. 6 (1977); Mark J. Homer, 36 T.C.M. 83 (1977); Vance L. Alexander, 36 T.C.M. 673 (1977).

The source and dollar limitations of section 117(b) do not apply to degree candidates. A degree candidate may exclude from gross income any amount received in support of his studies or research provided such amount does not constitute earned income 1/ and provided the amount received is for study or research related to the course of study for which the taxpayer is registered as a degree candidate. 2/ "Amounts received for teaching, research, or other services required of all candidates for a degree as a condition to receiving such degree" are not regarded as earned income. The exclusion for amounts received as reimbursement for expenses of travel, research, clerical help and equipment incident to the excludable portion of the grant applies also to degree candidates. 3/

The "practice teaching" exception to the earned income rule is perceived as unfair

The exclusion for degree students of earned income received for part-time "practice teaching" has been a source of endless taxpayer controversy. The Internal Revenue Service, supported by the courts, has limited the exclusion in accordance with the criteria of regulation section 1.117-4(c) and the Senate Finance Committee Report. In particular,

---

1/Marjorie E. Haley, 54 T.C. 642 (1970); Reiffen v. U.S., 376 F. 2d 883 (Ct. Claims, 1967). The criterion is whether taxpayer is "paid to learn" (compensation) or "learns for pay" (scholarship). Norman F. Stougaard, 30 T.C.M. 1331 (1971); Norman H. Brown, 31 T.C.M. 457 (192). Even though the compensation received by a degree candidate from his employer is fully taxable, amounts received as tuition reimbursement or paid directly to the school are excludable. Bingler v. Johnson, 394 U.S. 741, 744 (1969); see also facts in John E. MacDonald, Jr., 52 T.C. 386 (1969); Ulak v. U.S., 345 F. Supp. 1269 (D.C. Calif., 1972); regulations section 1.162-17(b)(i). See also case 5, chapter 4, infra. and cases cited. Tuition remission by the school also is excludable although compensation received from the school for part-time teaching or research is taxable. Merrill L. Meehan 66 T.C. 794 (1976); Michael J. Larsen, 32 T.C.M. 1118 (1973).

2/Melvin H. Weiner, 64 T.C. 294 (1975).

3/A scholarship grant may include amounts received for board and room or as a living allowance if not paid by a present or former employer. Robert H. Kyle, T.C.M. 327 (1972).

stipends paid by colleges and universities to graduate students who perform research or teaching services in connection with their educational program are includable in the income of the student and subject to withholding of tax at source by the school. 1/

With respect to both degree and nondegree students, the effect of these rules is to make a distinction between grants made to persons whose learning takes place in a formal academic setting and those whose learning takes place in a "learning-by-doing setting." 2/ Taxpayers, principally licensed medical doctors working as medical interns or residents, and graduate degree candidates who perform research or teaching services in connection with their educational

---

1/Robert N. Worthington, 31 T.C.M. 447 (1972) aff'd 476 F. 2d 589 (10th Cir. 1973) (NDEA grant); Beulah M. Woodfin, 31 T.C.M. 208 (1972), appeal dismissed (National Science Foundation grant); Steinmetz v. U.S., 343 F. Supp. 384 (N.D. Cal., 1972), Michaels v. U.S., 71-1 USTC par. 9455, (E.D. Mich. 1971); Harvey P. Uteeh, 55 T.C. 434 (1970); Harry L. Kreis, 29 T.C.M. 770 (1970), aff'd, per curiam, 441 F. 2d 457 (4th Cir. 1971); Edward R. Jamieson, 51 T.C. 635 (1969); Kenneth J. Kopecky, 27 T.C.M. 1061 (1968); Donald R. DiBona, 27 T.C.M. 1055 (1968). Allen J. Workman, 33 T.C.M. 16 (1974) (graduate teaching assistantship); Frank C. Gibb, 32 T.C.M. 784 (1973); aff'd per curiam 501 F. 2d 1086 (6th Cir. 1974); Merrill Lee Meehan, 66 T.C. 794 (1976). Margaret L. Pelz, 551 F. 2d 291 (Ct. Cl. 1977), approving Trial Judges Report, 76-2 USTC 9775 (Ct. Cl. 1976). Nicholas V. Findler, 35 T.C.M. 1602 (1976). Logan v. U.S., 518 F. 2d 143 (6th Cir. 1975), rev'g D.C., Ohio, 73-2 USTC Par. 9717, (1973).

2/The difficulty, of course, of attempting to exclude personal service income on the ground that the taxpayer received training or education on the job is that all jobs have a "teaching" element to some extent. This fact underlies judicial support for the quid pro quo requirement of the regulations. See, for example, statement of the Tax Court in James J. Ferrero, 35 T.C.M. 388 (1976) at p. 390: "While petitioner quite obviously benefited from the experience and training he received, that does not mean that his stipend was a fellowship grant. Most workmen receiving compensation for their services learn from experience how to do their jobs more effectively. The payments they receive for those services are compensation, not grants, notwithstanding the beneficial training and experience."

programs, have refused to accept this distinction. 1/ They have continued to challenge the regulations by requests for administrative rulings, 2/ by contesting deficiencies based upon disallowance of the income exclusion, and by litigation. Despite the fact that the service has ruled specifically that 3/ amounts received by medical residents or interns who care for patients and amounts received by teaching fellows and research assistants who perform services for regular faculty members of the school where they are matriculated are taxable compensation, this issue remains a contested one. In some cases, the courts have regarded the section 117 exclusion as a "loophole" for a limited number of taxpayers. If the result is to treat taxpayers similarly situated in a different manner, "the remedy lies with Congress." 4/ More frequently the courts have expressed hostility to the flood of litigation created by section 117, in particular that brought by resident

---

1/The perceived unfairness of this distinction is exacerbated by the fact that the section 117 exclusion applies to payments made by the Government for tuition and certain other educational expenses of a member of the armed forces attending school under the Armed Forces Health Professions Scholarship Program or similar program, such as the Medical, Dental, and Veterinary Education program for Air Force Officers and the Navy Medical, and Osteopathic Scholarship Program. The payments qualify for exclusion pursuant to the provisions of section 4 of Public Law 93-483. Rev. Rul. 76-99, 1976-1 C.B. 40; Rev. Rul. 76-183, 1976-1 C.B. 43; Rev. Rul. 76-517, 1976-2 C.B. 38; Rev. Rul. 76-518, 1976-2 C.B. 39; Rev. Rul. 76-519, 1976-2 C.B. 39.

2/A record of cases closed by issue in the Office of the Chief Counsel shows 84 Interpretative Division section 117 cases closed by published rulings during the period January 1969 through September 1977. Rulings requests are less common in the educational expense deduction area. During this same period only 5 cases arising under regulations section 1.162-5 were closed by published revenue ruling.

3/See, for example, Rev. Rul. 65-117, 1965-1 C.B. 67; Rev. Rul. 71-417, 1971-2 C.B. 96; Rev. Rul. 76-252, 1976-2 C.B. 36.

4/Leathers v. U.S. 471 F. 2d 856 (8th Cir., 1972), aff'g 352 F. Supp. 1244 (E.D. Arl., 1971), cert., denied 412 U.S. 932 (1973).

doctors. This hostility was expressed by the Tax Court in Zonderman [1] as follows:

> "Interns and residents have been flooding the courts for years seeking to have their remuneration declared a "fellowship grant" and hence partially excludable from income. They have advanced such illuminating arguments as they could have earned more elsewhere and they were enjoying a learning experience so therefore what they did receive must have been a grant. They have been almost universally unsuccessful and deservedly so. Why the amounts received by a young doctor just out of school should be treated differently by a young lawyer, engineer, or business school graduate has never been made clear." (p. 9.)

DEDUCTION OF JOB-RELATED EDUCATIONAL EXPENSES

The statutory authority for deducting job-related educational expenses is section 162 of the Internal Revenue Code, which permits a deduction for "all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business." The determination of whether an individual is engaged in a trade or business and what is his trade or business is a question of ultimate fact. In general, carrying on a trade or business includes all activities by which an individual earns a living through work. Excluded from the business expense category are expenditures which are extraordinary (i.e., "unreasonable") in amount, are capital in nature, or are personal.

Under the section 162 regulations applicable to business expenses, generally the first issue to be determined is always that of whether a particular outlay qualifies as a business expense or as a nonbusiness (i.e., personal consumption) expense. Thus, travel expenses "directly attributable" to a taxpayer's job are deductible. Commuting expenses (a consumption expenditure) are not deductible. Regulations section 1.162-2(a). The second question to be determined is that of whether a particular business-related outlay is capital or ordinary in nature. For example, does an outlay for repairs "materially add to the value of the property" or "appreciably prolong its life" or does the repair expense merely maintain the asset "in an ordinary efficient operating condition"? Regulations section 1.162-4. If the former is true, the repair expense is regarded as an additional investment in the asset, depreciable over the life of the asset. If the latter is true, the repair expense is deductible currently.

---

[1] 36 T.C.M. 6 (1977).

The regulations applicable to the tax status of educational expenses import the capital expenditure concept into the classification of business-related educational expenses which represent an additional investment in human capital--either because the education is required to "meet the minimum educational requirements" of the job or because the education qualifies the taxpayer "for a new trade or business." This is a mistake in theory and a source of endless IRS-taxpayer controversy and confusion. The capital expense concept is an irrelevant concept for purposes of determining whether an expenditure made by a natural person for his own benefit should be allowed as a deduction for purposes of measuring ability to pay. Further, application of the capital expense concept to expenditures made by a natural person for his own benefit is confusing because it does not correspond with the sense of the everyday use of the notion of capital investment.

The value of the individual himself, considered as a capital asset capable of creating income, is a relevant concept for national income accounting purposes where the object is to measure the effect of outlays for education, training, health care, and mobility on economic growth. 1/ It may also

---

1/It has been suggested by economists, in particular by Edward F. Denison, Moses Abramovitz, and John S. Kendrick, that the investment component in the national income accounts be expanded to include all outlays which have the effect of expanding future output and income-producing capacity. The concept of investment in human capital is used as an analytical framework for components of growth rates among countries. See, for example, Edward F. Denison, Why Growth Rates Differ (Washington, D.C., The Brookings Institution, 1967). For purposes of productivity analysis, the stock of education and training represents the productive knowledge and know-how embodied in human beings; the stock of health and mobility represents the cumulative outlays for these purposes embodied in the population.

be a relevant concept for purposes of measuring the yield derived from a given income source, here earned income. 1/

However, since the nineteenth century in England and in the United States, the income tax has been viewed as a personal tax, imposed upon net taxable income regarded as a measure of financial capacity. This means that for definition of income purposes the individual cannot be regarded as a depreciable capital asset and any investment which he may make in his own health, mobility, or education cannot create a separate amortizable asset. Such expenses can only be either personal (consumption) in nature or business related. 2/

The "primary purpose" test of the 1958 regulations was difficult to administer

As a practical matter it is virtually impossible to apply these rules in an even-handed manner. Treasury regulations issued under section 162 in 1958 3/ and again in 1967 4/ attempt to set forth rules by which to determine

---

1/William Vickrey in *Agenda For Progressive Taxation* (August M. Kelly, reprint, 1972) suggests that, for purposes of refining the definition of earned income, "logically" an amortization deduction should be allowed for educational costs incurred to obtain job-related "technical training" but not for the costs incurred to obtain "a liberal arts education" which does not directly increase earning power. However, because of the difficulty of correlating educational costs with enhanced earning ability, he did not recommend a specific rule for the recovery of training costs through amortization. In his concluding "Agenda" Vickrey listed his suggestion that training expenses be amortized out of subsequent income under the heading "further refinements requiring relatively large additional auditing and administration expense."

2/The capital-noncapital criterion has been avoided with respect to expenditures for health care and for job-related moving costs by specific statutory provisions which treat the former as currently deductible personal expenses and the latter as currently deductible offsets against gross income to reach adjusted gross income.

3/T.D. 6291.

4/T.D. 6918.

whether an educational expense is personal or business related and, if the latter, whether it is capital or ordinary in nature. The 1958 regulations adopted a subjective "primary purpose" test in recognition of the fact that an individual's educational activities may reflect several motives, none of which may be apparent from the course of study pursued. Thus, the 1958 regulations allowed a deduction for the expenses of study undertaken "primarily for the purpose" of (1) maintaining or improving skills required by the individual in his employment or (2) for meeting the express requirements of a taxpayer's employer, or of applicable law or regulations imposed as a condition to the retention by the taxpayer of his employment. 1/ A deduction was not allowed for the expenses of education undertaken "primarily for the purpose" of obtaining a new or higher position or for personal reasons.

Under the 1958 regulations, taxpayers could not deduct educational expenses for courses of study that would qualify them for a new trade or business unless such education was "required as a condition to the retention by the taxpayer of his present employment." 2/ Expenses for travel regarded as a form of education also were not deductible. 3/

The "maintaining skills" and "express requirements" criteria of the regulations were based on language in two Circuit Court decisions, Hill v. Commissioner, 4/ and Coughlin v. Commissioner. 5/ In Hill, a teacher seeking renewal of her teaching license was allowed to deduct summer school expenses incurred to satisfy the renewal requirement. In Coughlin, an attorney was allowed to deduct expenses incurred to attend a Federal Tax Institute. Under the 1958 regulations the "maintaining skills" rule could be satisfied by a showing that "it is customary for other established members of the taxpayer's trade or business to undertake such education." 6/ The "requirements of an employer" rule could be satisfied by a showing that the education was undertaken "primarily for a

---

1/Regulations section 1.162-5(a)(1) and (2).

2/Regulations section 1.162-5(b).

3/Regulations section 1.162-5(c).

4/181 F. 2d 906 (4th Cir., 1950).

5/203 F. 2d 307 (2d Cir., 1953).

6/Regulations section 1.162-5(a).

bona fide business purpose of the taxpayer's employer and not primarily for the taxpayer's benefit." 1/

The "maintains or improves skills" test of the 1967 regulation is difficult to understand

The results of the 1958 regulations were chaotic. Application of the primary purpose test on a case-by-case basis resulted in a difference in tax treatment among individuals similarly situated. Further, on trial, taxpayers encountered serious problems of proof of the requisite subjective intent. Accordingly, after extensive hearings and redrafts, the Commissioner, in 1967, promulgated new regulations which withdrew both the "primary purpose" and the "customary" tests. The 1967 regulations liberalize the deduction of educational expenses incurred by teachers, overturn the Treasury rule that educational travel is not deductible, and specifically disallow a deduction for the costs of education which qualifies the taxpayer for a new trade or business, whether or not the taxpayer intends to pursue the new trade or business. 2/ For example, under the 1967 regulations an accountant who goes to law school at night cannot deduct the costs incurred even though he intends to continue working as an accountant and in fact never practices law a day in his life. On the other hand, the regulations provide that a change of duties does not constitute a new trade or business if the duties involve the same general type of work. The only examples of the kind of change of duties which qualifies as "the same general type of work" pertain to teachers. The question of what constitutes "the same general type of work" for business and professional men is a new and additional source of controversy created by the 1967 regulations.

While the 1967 regulations make a sharp distinction between costs incurred to "maintain" earning capacity (deductible) and costs incurred to create new earning capacity or augment existing earning capacity (nondeductible), they do not make a distinction for tax purposes between expenses of

---

1/id.

2/Regulations section 1.162-5(b)(3). The effect is to prohibit accountants, businessmen, or even lawyers qualified to practice law in a foreign country, but not in the U.S., from deducting the costs of obtaining a legal education. Yaroslaw Horodysky, 54 T.C. 490 (1970).

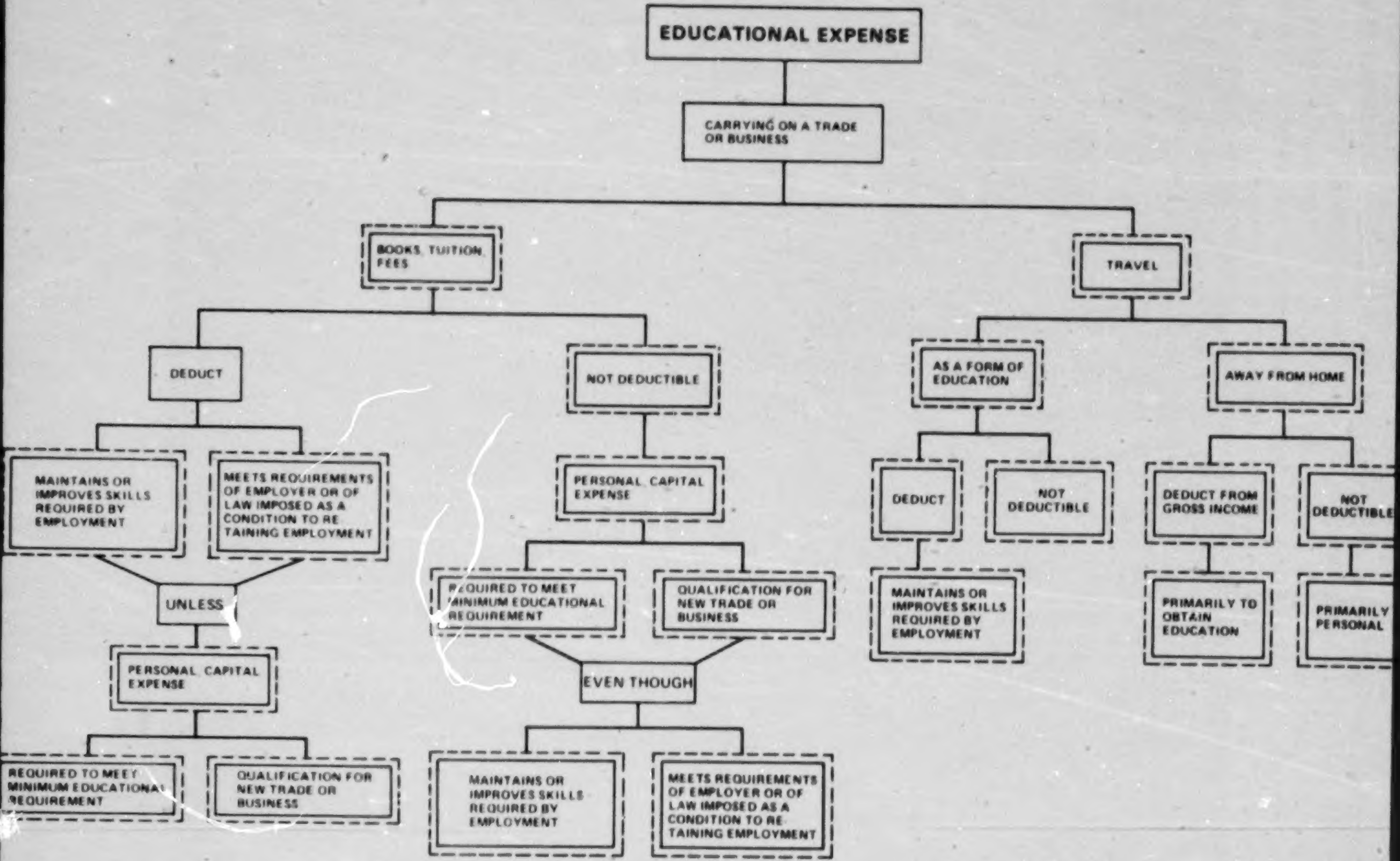
education as preparation for living (personal) and expenses of education as preparation for earning (capital). 1/ The result is to treat job-related educational expenses for courses of study which go beyond the maintenance of basic, minimum skills in the same manner as purely personal outlays. 2/ Neither kind of educational expense is deductible.

The structure of the 1967 regulations is confusing

The 1967 regulations have created difficult problems of interpretation and require many more factual determinations than were required by the 1958 regulations. Further, the structure of the regulations is confusing. As in the case of section 117, it may be helpful in following an analysis of regulations section 1.162-5 to use the chart set forth below. The sole statutory criteria, namely, that the individual be engaged in a trade or business and that the expenses be related to the carrying on of such trade or business are enclosed in boxes drawn with solid lines; the related regulations criteria are enclosed in boxes drawn with dotted lines. Interrelationships among rules are denoted by solid lines. (See p. 31 for chart.)

1/Regulations section 1.162-5(b)(1).

2/There have been some fairly bizarre attempts by taxpayers to turn this confusion between education for consumption and education for the creation of earning capacity into a theory for the tax deductibility of educational expenses generally. For example, in Joel A. Sharon, 66 T.C. 515 (1976) taxpayer, an IRS attorney attempted to amortize the cost of obtaining his license to practice law in New York over the period from admission to the bar to the date when he would reach age 65. Included in the cost basis of the license was the costs of obtaining his undergraduate B.A. degree ($11,125), of obtaining his LLB degree ($6,910), of a bar review course ($175.20) and the New York State bar examination fee ($25). Taxpayer contended that these educational expenses were properly added to the cost basis of his license (an intangible asset) because graduation from an accredited college and law school was a condition precedent to qualifying to take the bar examination. The Tax Court disallowed an amortization deduction for the educational expenses on the ground that such expenses were personal and could not be capitalized. Alternatively, even if capital in nature, the educational costs could not be recovered because the period of use was uncertain. However, the $25 fee as well as costs and fees incurred to gain admission to the California bar were allowed to be amortized over the taxpayer's life expectancy.


EDUCATIONAL EXPENSE
CARRYING ON A TRADE OR BUSINESS
BOOKS, TUITION, FEES
TRAVEL
DEDUCT
NOT DEDUCTIBLE
AS A FORM OF EDUCATION
AWAY FROM HOME
MAINTAINS OR IMPROVES SKILLS REQUIRED BY EMPLOYMENT
MEETS REQUIREMENTS OF EMPLOYER OR OF LAW IMPOSED AS A CONDITION TO RETAINING EMPLOYMENT
PERSONAL, CAPITAL EXPENSE
DEDUCT
NOT DEDUCTIBLE
DEDUCT FROM GROSS INCOME
NOT DEDUCTIBLE
UNLESS
REQUIRED TO MEET MINIMUM EDUCATIONAL REQUIREMENT
QUALIFICATION FOR NEW TRADE OR BUSINESS
MAINTAINS OR IMPROVES SKILLS REQUIRED BY EMPLOYMENT
PRIMARILY TO OBTAIN EDUCATION
PRIMARILY PERSONAL
PERSONAL, CAPITAL EXPENSE
EVEN THOUGH
REQUIRED TO MEET MINIMUM EDUCATIONAL REQUIREMENT
QUALIFICATION FOR NEW TRADE OR BUSINESS
MAINTAINS OR IMPROVES SKILLS REQUIRED BY EMPLOYMENT
MEETS REQUIREMENTS OF EMPLOYER OR OF LAW IMPOSED AS A CONDITION TO RETAINING EMPLOYMENT

The regulations are structured as follows. A deduction is allowed for tuition, books, fees, and related travel expenses if the education "(1) Maintains or improves skills required by the individual in his employment or other trade or business, or (2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship status, or rate of compensation" unless the expenditures are for education

> "to meet the minimum requirements for qualification or establishment in * * * /a/ trade or business or speciality therein * * *.
>
> "A deduction is not allowed for expenditures for education "to meet the minimum requirements for qualification or establishment in * * * /a/ trade or business or speciality therein."

Even though the expenditures are undertaken primarily for the purpose of:

> "(1) Maintaining or improving skills required by the taxpayer in his employment or other trade or business, or (2) Meeting the express requirements of a taxpayer's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his salary, status, or employment

The circularity of the reasoning underlying the regulations rules applicable to tuition, books, fees, and related travel expenses is readily apparent [illegible] capital Roman letters are substituted for each of the criteria. Let A refer to the "maintains skills" criterion and B refer to the "express requirements" of the employer criterion. Let C refer to the "minimum requirement" rule as applied to taxpayer's present job and D refer to the "qualification for a new trade or business" rule. The regulation then would read: Deduct if A or B is true unless C or D is true. Do not deduct if C or D is true even though A or B also is true. Not surprisingly, administrative and judicial interpretation of these rules has not produced a coherent body of precedent or provided certainty.

Travel expenses may be treated as a form of education or as a cost of education

The rules governing the deductibility of educational travel expenses are far less complicated than those pertaining to the deduction of books, fees, and tuition. The expenses of travel as a form of education are deductible if the travel is "directly related to the duties of the individual in his employment or other trade or business." Despite the simplicity of this rule, deficiencies based upon disallowance of educational travel expenses have generated a significant amount of controversy, principally by teachers. The expenses of travel away from home are deductible as an educational expense if incurred primarily to obtain an education, the expenses of which are deductible. 1/

There is a further complication: the expenses of travel as education as well as the cost of books, tuition, and fees are deductible from gross income to reach adjusted gross income if the individual is self-employed. However, if the individual is an employee, such expenses are deductible from adjusted gross income to reach taxable income. 2/ Travel expenses incurred to obtain an education, however, are always deductible from gross income to reach adjusted gross income. 3/ This means that if an individual who is an employee elects to take the standard deduction, he can deduct his education-related travel expenses but not the costs of tuition, books, and fees. A self-employed person can deduct all qualified educational expenses whether or not he elects the standard deduction.

1/The "education as travel" issue accounted for only five educational expense cases initially covered by the Appellate Division sample. These five were removed from the sample base because this report is concerned primarily with the taxability of grants and expenses for tuition, fees, books, and related costs.

2/T.I.R. No. 83, June 30, 1958; W. E. Thompson, 16 T.C.M. 271 (1957); Hartrick v. U.S., 205 F. Supp. 111 (N.D. Ohio, 1962).

3/Section 162(a)(2), subject to the substantiation requirements of section 274(d) and regulations section 1.274-5.

The deduction rules do not mesh with the exclusion rules

In addition to the interpretative problems created by the confusing structure of the regulations, the separate rules governing the deduction of educational expenses do not mesh with the income exclusion rules of section 117. For example, the "carrying on a trade or business" requirement is not met in the case of an individual who takes a leave of absence from his regular employment in order to further his education. 1/ If, to assist the individual in this circumstance, the employer finances the cost of such education, the amount received probably would be regarded as compensation for past or future services and hence not excludable under section 117. The expenses incurred, on the other hand, are not deductible because the taxpayer, not currently employed, is not engaged in trade or business. 2/

Proceeding down the left-hand side of the chart on page 31 under the rules pertaining to deduction, the "maintains or improves skills" criterion is the source of the largest number of disputes. This one criterion essentially involves all of the other separately stated criteria. As a practical matter, it is difficult to prove that an educational expenditure maintains or improves skills required by one's employment but is not undertaken to meet the minimum educational requirements of this same job and does not so far improve one's skills that the individual qualifies himself for a new and better job. The distinction is one between existing skills, nonexistent skills, and new skills. Educational expenses incurred to maintain or improve a skill which the taxpayer already has are deductible. However, if the taxpayer has been employed to do a job for which he is not qualified, he may not deduct educational expenses incurred

---

1/Richard M. Randick 35 T.C.M. 195 (1976); Rev. Rul. 60-97, 1960-1 C.B. 69; Rev. Rul. 68-591, 1968-2 C.B. 73; Don E. Wyatt, 56 T.C. 517 (1971); in Cantor v. U.S., 354 F 2d 352 (Ct. Claims, 1965) the court stated that "the mere existence of professional status is not a sufficient basis for finding that the taxpayer is carrying on a trade or business."

2/Rev. Rul. 60-97, 1960-1 C.B. 69, 70; Burke Bradley 54 T.C. 216 (1970).

to gain the needed skills. 1/ Further, if the taxpayer is qualified to do the job for which he is employed, he may not deduct educational expenses incurred to improve his skills and thereby to merit a promotion. 2/

The regulations do not treat employees and self-employed persons alike

A further difficulty with the "meets the requirements of the employer" criterion is that it creates an inequitable distinction between self-employed persons and employees. In the latter situation the employer's judgment is required to justify the deduction even though it is the employees' own money that is invested in his self-improvement. Furthermore, there is an overlap between the "maintains or improves skills" and the "meets requirements of the employer" criterion. In order to satisfy the latter rule the expenditure must be incurred for a bona fide business purpose of the employer. 3/ However, any educational outlay made by an employee for a bona fide purpose of his employer necessarily maintains or improves skills required by this same employment. 4/ It is difficult to surmise what was intended by phrasing what appears to be a single criterion as two separate rules.

The disallowance rules of the regulations duplicate the allowance rules

Proceeding down the column of rules applicable to nondeductible, personal, or capital expenditures for education, we have exactly the same criteria as under the rules relating to the deduction of educational expenses--but in

---

1/Robert Kamins, 25 T.C. 1238 (1956). Regulations section 1.162-5(b)(2)(ii) contain specific examples applicable to teachers.

2/Lewis Kendrick, 26 T.C.M. 339 (1967); Allen Kandell, 30 T.C.M. 1227 (1971); Richard P. Joyce, 28 T.C.M. 1333 (1969); William Kinch, 30 T.C.M. 502 (1971).

3/Regulations section 1.162-5(c)(2) (1967); Nathan Fleischer, 403 F 2d 403 (2d Cir., 1968); 30 T.C.M. 699 (1971); Burke W. Bradley, 54 T.C. 216 (1970).

4/This is true especially in situations where the educational requirement is imposed *after* the individual has entered the employment. Laurie Robertson, 37 T.C. 1153 (1962).

reverse order. Under the rules governing disallowance of the deduction, expenses incurred for courses of study designed to increase the taxpayer's general understanding and competency are a nondeductible consumption item. 1/ Educational expenses incurred for courses of study designed to create new earning capacity (for example, to qualify taxpayer for a new trade or business) are a nondeductible capital outlay even though the courses also maintain or improve existing job-related skills or are required by the employer. 2/

Expenses of travel (including meals and lodging) away from home undertaken to obtain an education are subject to the rules of Code sections 162(a)(2) and 274. The rules of Treasury regulations section 1.162-5 pertaining to educational expenses restate or incorporate by reference the rules of Code sections 162(a)(2) and 274, subject to the restriction that the travel be incurred in connection with education for which the costs are deductible. 3/ This

---

1/Barry Reisine, 29 T.C.M. 1429 (1970); James Carroll, 51 T.C. 213 (1968), aff'd 418 F. 2d 91 (7th Cir., 1969); the criterion can be stated: Is taxpayer's study undertaken to permit him to be employed or is his employment undertaken to permit him to study? Stanley G. Betz, 30 T.C.M. 119 (1971). Regulations sections 1.262-1(b)(5) and (9).

2/Myron Burnstein, 66 T.C. 492 (1976). The 1967 regulations liberalized deductions for educational expenses incurred by teachers by providing that "all teaching and related duties shall be considered to involve the same general type of work." Regulations section 1.162-5(b)(3)(i) (1967). However, changes of duties within other types of work generally involve a new trade or business. In particular, law school expenses are not deductible even though the individual applies the training to improve his skills as an accountant, an insurance claims adjustor, or patent trainee and does not engage in the active practice of law after graduation. Regulations section 1.162-5(b)(3)(iii), Examples (1) and (2) (1967). Bernd Sandt, 20 T.C.M. 913 (1961), aff'd 303 F 2d 111 (3rd Cir., 1962); Owen Lamb, 46 T.C. 539 (1966); John K. Lunsford, 32 T.C.M. 64 (1973); Ronald F. Weiszman, 483 F. 2d 817 (10th Cir., 1973), aff'g 31 T.C.M. 1201 (1972); Jeffry S. Augen, 33 T.C.M. 1022 (1974); Rombach v. U.S., 440 F. 2d 1356 (Ct. Cl., 1971).

3/Regulations section 1.162-5(e)(1)(1967); Rev. Rul. 76-65, 1976-1 C.B. 46.

means that deductibility of the expense of travel to obtain an education is, in most cases, determined by the deductibility of the underlying expenditure. 1/ However, this does not mean that personal travel expenses, as for commuting and vacation trips, are deductible if incurred in connection with deductible education. 2/ The regulations require that an allocation be made to separate the travel for deductible educational purposes from the personal activities but give no specific rules for allocation. 3/

Under the 1967 regulations, educational travel expenses are deductible if the major portion of activities carried on during the travel period directly maintains or improves the individual's required job skills. 4/ The 1958 regulations considered educational travel expenses as primarily personal in nature and denied deductibility. 5/ Taxpayers contesting tax deficiencies based upon disallowance of a deduction for educational travel expenses are almost exclusively teachers. The contention is that travel, which for others would be of a kind that is purely for recreational

---

1/The regulations pertaining to travel to obtain education are substantially the same as the 1958 regulations. The subjective "primary purpose" test has been retained. The principal change relates to the addition in 1962 of the substantiation rules of section 274(d).

2/J. L. Denison, 30 T.C.M. 1074 (1971); Gerhard Boerner, 30 T.C.M. 240 (1971); Robert Burton, 30 T.C.M. 243 (1971).

3/Regulations section 1.162-5(e)(2).

4/Regulations section 1.162-5(d) (1967).

5/Regulations section 1.162-5(c) (1958). The Treasury relaxed its restrictive rules after a series of court decisions allowing deductions of expenses where the travel was "ordinary and necessary" and the travel was directly related to job skills required in taxpayer's business or profession. Alan James, 23 T.C.M. 385 (1964); Evelyn Sanders, 19 T.C.M. 323 (1960). In Revenue Ruling 640176, 1964-1 C.B. 87 the Service announced that it would allow a deduction for the expenses of travel "which has a direct relationship to the conduct of the individual's trade or business."

and personal purposes, is related to their duties as teachers. 1/

The "maintains and improves skills" criterion is perceived as unfair

Much of the litigation in the educational expense area is trivial and time consuming. 2/ The principal litigants are teachers who claim a deduction for educational travel and professional persons who claim a deduction for law school expenses. Just as the resident medical doctor can argue with some plausibility that he "learns by treating patients," so the teacher can argue that travel stimulates enthusiasm for teaching, 3/ and the business or professional

---

1/Gladys Smith, 26 T.C.M. 1281 (1967); Helen Oehlke, 26 T.C.M. 663 (1967); Bruce Steinmann, 30 T.C.M. 1251 (1971); Alan James, 23 T.C.M. 385 (1964); Paul R. Dougherty, 29 T.C.M. 186 (1970); Zella V. Statton, 28 T.C.M. 1278 (1969). In denying a teacher's claim for deduction of educational expenses, the District Court of Texas in Fugate v. U.S. 259 F. Supp. 398, 401 (1966) stated, "The trip was not taken primarily to help them maintain or improve their skills. They took a regular tour with a group of people. There was nothing about it that was any more suited for a teacher than for some widow who was traveling on the proceeds of her husband's life insurance."

2/For example, in Arthur E. Tyman, Jr., 51 T.C. 799 (1969) taxpayer, an attorney employed as a teacher in an accredited law school litigated for 6 years in an attempt to over turn a tax deficiency based upon disallowance of a deduction for $126 paid as a fee for admission to the Iowa bar and $177.17 expense incurred to give a party in celebration of this event. The total tax deficiency proposed and sustained was $67. In Keith W. Shaw, 28, T.C.M. 626 (1969) taxpayer, a licensed medical doctor, claimed as an educational expense the costs of fuel and depreciation of his private airplane, used to "maintain his flying skills" needed in his job as a Federal Aviation Administration medical examiner.

3/Esther M. Rosenberg, 28 T.C.M. 1183 (1969).

man that law is helpful in any kind of business-oriented employment. 1/

However, there is a real issue of equity underlying the educational expense deduction cases which keeps this issue area from being resolved through the courts. The regulations are liberal in their treatment of job-related educational expenses incurred by persons in the teaching profession. 2/ They are restrictive in their treatment of educational expenses incurred by persons employed in non-teaching jobs. 3/ While taxpayers have not been successful in overturning the regulations on the ground that they unconstitutionally discriminate in favor of persons employed in the teaching professions, the regulations are perceived

---

1/Marshall L. Helms, Jr., 27 T.C.M. 1020 (1968). In denying a claim for law school expenses incurred by an insurance claims adjustor the Tax Court, in John V. McDermott, Jr., 36 T.C.M. 144, 145-146 (1977) stated "* * * The expense of legal skills by accountants, patent specialists, and other professionals is a trade or business separate and distinct from the practice of law." Jeffry R. Weiler, 54 T.C. 398 (1970); Lawrence H. Bakken, 51 T.C. 603 (1969); aff'd 435 F. 2d 1306 (9th Cir., 1971). On the other hand, expenses incurred by a practicing tax lawyer to obtain an LLM degree in taxation are deductible. Albert C. Ruehmann III, 30 T.C.M. 675 (1971); Contra, Johnson v. U.S., 332 F. Supp. 906 (D.C. La., 1971); Henry C. Reinhard, Jr., 34 T.C.M. 1529 (1975).

2/See John D. Ford, 56 T.C. 1300 (1971); aff'd 487 F. 2d 1025 (9th Cir., 1973); David N. Weiman, 30 T.C.M. 372 (1971); Paul R. Dougherty, 29 T.C.M. 186 (1970); Furner v. Commissioner, 393 F 2d 292 (7th Cir., 1968).

3/A public accountant may not deduct the cost of studies required to qualify as a certified public accountant. William D. Glenn, 62 T.C. 270 (1974). A highway technical-trainee may not deduct the cost of studies required to attend a work-study program in highway technology even though such studies are required by his employer, a State highway department. Wayne L. Wentworth, 33 T.C.M. 128 (1974). An intern pharmacist may not deduct the cost of studies leading to certification. Gary Antzonlatos, 34 T.C.M. 1426 (1975). A research chemist employed as a patent trainee may not deduct the cost of law school studies which would qualify him as a patent attorney. Rombach v. U.S., 440 F 2d 1356 (Ct. Cls. 1971).

by many taxpayers to be unfair. 1/ Tax law rules widely regarded as unfair are, for this reason alone, difficult to administer and give rise to taxpayer-IRS controversies 2/ which resist settlement. Adding the element of unfairness to the admitted complexity of the rules prescribed by regulations section 1.162-5 ensures that this issue area will remain unsettled if the present rules are not changed.

1/For example, see Robert Connelly, 30 T.C.M. 376 (1971); dissenting opinion of Judge Tannewald in John Ford, 56 T.C. 1300, 1312 (1971); Morton S. Taubman, 60 T.C. 814 (1973); Richard H. Gaines, 35 T.C.M. 1415, 1417 (1976).

2/For example, taxpayer, an auditor, in Robert C. Smith, 29 T.C.M. 972 (1970) litigated a $54 tax deficiency for 4 years based upon disallowance of $285 educational expenses incurred to qualify as a certified public accountant.

CHAPTER 3

CHARACTERISTICS OF TAXPAYERS

This section details the characteristics of taxpayers who claim an exclusion under section 117 for amounts received for study or for services rendered (i.e., research and teaching) or who claim a deduction under regulations section 1.162-5 for job-related educational expenses. The purpose of the section 117 exclusion and of the regulations under section 162 is to provide clear-cut rules for determining whether an educational grant is taxable or an educational expense is deductible. Statistics of the cases in controversy under these two tax provisions indicate that the Congress and the Treasury have largely failed to accomplish the purpose intended. (See ch. 1.) The question then is: Who in fact bears the economic burden of interpretation?

The table below sets forth the principal occupational categories of all taxpayers in the sample of cases in controversy at the Appellate Division level and of all litigants in the decided cases indexed under these issues. 1/ Taking pending Appellate Division cases and decided cases together, the principal contesters are licensed medical doctors (employed as residents or interns in hospitals) teachers, and government employees. There is no significant difference in occupational grouping between taxpayers who have litigated their tax dispute through to a final decision and those presently involved in the administrative settlement process. That is, the proliferation of legal precedent does not appear to be resolving the interpretative problems encountered by taxpayers in these occupational groups. It has not reduced the number of deficiencies contested by taxpayers in these occupations.

1/Our sample consisted of 257 open Appellate Division cases and the total number--281--of cases litigated through to a written opinion during the period July 1967 through June 1977.

Occupational Categories--Educational Tax Issues

Occupation	Appellate Division cases No.	Appellate Division cases Percent	Decided cases No.	Decided cases Percent
Teacher	48	18.7	52	18.5
Medical related	12	4.7	10	3.6
Licensed MD	100	38.9	109	38.8
Engineer	6	2.3	27	9.6
Business	13	5.1	24	8.5
Law and accounting	6	2.3	11	3.9
Government	20	7.8	27	9.6
Science	12	4.7	4	1.4
Misc. research	6	2.3	3	1.1
Other	6	2.3	8	2.8
No occupation	28	10.9	5	1.8
Occupation unknown	0	0	1	.4
Total	257	100.0	281	100.0

Comparison of the occupational grouping of all contesters with that of contesters in each of the three issue areas shows that teachers predominate in controversies involving the exclusion of scholarship and fellowship grants received by degree students as well as in controversies based upon disallowance of a deduction for job-related educational expenses. Full-time graduate students, who work as part-time instructors or teaching assistants in the graduate departments where they are enrolled, also comprise a substantial group of contesters under the degree student issue category. Government employees are second after teachers in contesting deficiencies based on the disallowance of job-related educational expenses. Licensed medical doctors employed in hospitals as residents or interns predominate in cases involving the exclusion of grants received by nondegree students.

Occupational Categories--Degree Students

	Appellate Division cases		Decided cases	
Occupation	No.	Percent	No.	Percent
Teacher	22	32.8	16	26.2
Medical related	5	7.5	5	8.2
Licensed MD	11	16.4	6	9.8
Engineer	0	0	15	24.6
Business	1	1.5	4	6.6
Law and accounting	0	0	0	0
Other	0	0	0	0
Government	5	7.5	11	18.0
No occupation	19	28.4	3	4.9
Science	2	3.0	0	0
Misc. research	2	3.0	1	1.6
Total	67	a/100.1	61	a/ 99.9

Occupational Categories--Nondegree Students

	Appellate Division cases		Decided cases	
Occupation	No.	Percent	No.	Percent
Teacher	6	5.7	6	5.1
Medical related	2	1.9	3	2.5
Licensed MD	86	81.1	101	85.6
Engineer	0	0	0	0
Business	0	0	1	.8
Law and accounting	0	0	1	.8
Other	0	0	0	0
Government	0	0	1	.8
No occupation	1	0.9	0	0
Science	8	7.5	3	2.5
Miscellaneous research	3	2.8	2	1.7
Total	106	a/99.9	118	a/99.8

a/Percentages do not equal 100 due to rounding.

Occupational Categories--Educational Expenses

Occupation	Appellate Division cases No.	Appellate Division cases Percent	Decided cases No.	Decided cases Percent
Teacher	20	23.8	30	29.4
Medical related	5	6.0	2	2.0
Licensed MD	3	3.6	2	2.0
Engineer	6	7.1	12	11.8
Business	12	14.3	19	18.6
Law and accounting	6	7.1	10	9.8
Other	6	7.1	8	7.8
Government	15	17.9	15	14.7
No occupation	8	9.5	2	2.0
Science	2	2.4	1	1.0
Miscellaneous research	1	1.2	0	0
Occupation unknown	0	0	1	1.0
Total	84	100.0	102	100.1

a/Percentages do not equal 100 due to rounding.

Most taxpayers in the sample of Appellate Division cases and most litigants in the decided cases are married, filing a joint return.

Marital Status--Degree Students

Filing status	Appellate Division cases No.	Appellate Division cases Percent	Decided cases (note a) No.	Decided cases (note a) Percent
Single	16	23.9	18	31.0
Married, joint return	49	73.1	40	69.0
Married, separate return	0	0	0	0
Head of household	2	3.0	0	0

a/In three cases the filing status of the taxpayer is not known.

Marital Status--Nondegree Student

Filing status	Appellate Division cases		Decided cases (note a)	
	No.	Percent	No.	Percent
Single	21	19.8	31	26.7
Married, joint return	80	75.5	84	72.4
Married, separate return	5	4.7	1	.9
Head of household	0	0	0	0

a/In two cases the filing status of the taxpayer is not known.

Marital Status--Educational Expenses

Filing Status	Appellate Division Cases		Decided Cases	
	No.	Percent	No.	Percent
Single	22	26.5	32	31.4
Married, joint return	53	63.9	70	68.6
Married, separate return	4	4.8	0	0
Head of household	4	4.8	0	0

Comparison of the average marginal tax rates for the sample of taxpayers contesting deficiencies at the Appellate Division level, broken down by issue, indicates that both degree and nondegree students claiming an exclusion for amounts received for study or research report relatively more taxable income, in addition to the amount received as a grant, than do taxpayers claiming a deduction for educational expenses.

Marginal Tax Rates--Degree Students

Marginal tax rate applicable to proposed deficiency	Appellate Division cases		Decided cases	
	No.	Percent	No.	Percent
Zero - 10%	30	44.7	5	8.2
11 - 15%	6	9.0	17	27.9
16 - 20%	15	22.4	17	27.9
21 - 25%	12	17.9	8	13.1
26 - 30%	3	4.5	2	3.3
31 - 35%	1	1.5	2	3.3
36% or above	0	0	3	4.8
Not known	0	0	7	11.5
Total	67	100.0	61	100.0

Marginal Tax Rates--Nondegree Students

Marginal tax rate applicable to proposed deficiency	Appellate Division cases		Decided cases	
	No.	Percent	No.	Percent
Zero - 10%	16	15.2	6	5.1
11 - 15%	8	7.5	11	9.3
16 - 20%	35	33.0	45	38.1
21 - 25%	30	28.3	34	28.9
26 - 30%	10	9.4	6	5.1
31 - 35%	4	3.8	5	4.2
36% or above	3	2.8	8	6.8
Not known	0	0	3	2.5
Total	106	100.0	118	100.0

Ordinarily, the average marginal tax rate applicable to a proposed deficiency is a reliable indicator of the financial resources of taxpayers. However, as explained more fully in chapter 4, the effect of the offset of the standard deduction against the increase in the income base attributable to disallowance of an educational expense deduction is to reduce the average marginal tax rate applicable to the proposed deficiency to less than the minimum statutory rate. The average marginal tax rate therefore is not a reliable indication of the financial capacity of taxpayers who claim a deduction for education expenses. The next best indicator of financial capacity is adjusted gross income level broken down by income source.

Adjusted Gross Income Levels--Appellate Division Cases

Income level	Degree students		Nondegree students		Educational expenses	
	No.	Percent	No.	Percent	No.	Percent
Zero - $4,999	17	25.4	9	8.5	6	7.1
$5,000 - $9,999	30	44.8	39	36.8	35	41.7
$10,000 - $19,999	15	22.4	36	34.0	24	28.6
$20,000 - $49,999	5	7.5	21	19.8	18	21.4
$50,000 and above	0	0	1	.9	1	1.2
Total	67	100.1	106	100.0	84	100.0

Income sources reported on the returns in the sample of pending Appellate Division cases show that the principal financial resource of taxpayers in all three issue categories is compensation income. The only other significant source of income reported is interest income received by nondegree candidates and taxpayers claiming the educational expense deduction. The dollar amount of income broken down by source of income is summarized in the following three tables. On balance, nondegree candidates appear to be considerably more prosperous than either degree candidates or employees who finance their education out of their own funds.

Income Sources of Taxpayers Who Claimed Income Exclusion As Degree Students

Source of Income--Appellate Division Cases (note a)

Dollar amount from source	Compensation		Dividends		Interest		Other	
	No.	Percent	No.	Percent	No.	Percent	No.	Percent
Zero (note b)	2	3.0	62	92.5	25	37.3	44	71.0
Less than $1,000	0	0	4	6.0	40	59.7	14	22.6
$1,000 - $4,999	9	13.4	1	1.5	2	3.0	3	4.8
$5,000 - $9,999	27	40.3	0	0	0	0	1	1.6
$17,000 - $19,999	17	25.4	0	0	0	0	0	0
$20,000 - $49,999	12	17.9	0	0	0	0	0	0
Total	67	100.0	67	100.0	67	100.0	62	100.0

a/The figures in each column represent the number and percentage of taxpayers who received the amounts of income shown from the stated sources.

b/Does not include deficit returns. Five degree students filed returns showing a net loss from other income sources.

Income Sources of Taxpayers Who Claimed Income Exclusion As Nondegree Students

Source of Income--Appellate Division Cases (note a)

Dollar amount from source	Compensation		Dividends		Interest		Other	
	No.	Percent	No.	Percent	No.	Percent	No.	Percent
Zero (note b)	1	0.9	68	64.2	27	25.5	49	50.5
Less than $1,000	1	0.9	34	32.1	70	66.0	22	22.7
$1,000 - $4,999	4	3.8	3	2.8	9	8.5	19	19.6
$5,000 - $9,999	37	34.9	1	0.9	0	0	2	2.1
$10,000 - $19,999	42	39.6	0	0	0	0	4	4.1
$20,000 - $49,999	21	19.8	0	0	0	0	0	0
$50,000 or more	0	0	0	0	0	0	1	1.0
Total	106	99.9	106	100.0	106	100.0	97	100.0

a/The figures in each column represent the number and percentage of taxpayers who received the amounts of income shown from the stated sources.

b/Does not include deficit returns. Nine nondegree students filed returns showing a net loss from other income sources.

Income Sources of Taxpayers Who Claimed Business-Related Educational Expense Deduction

Source of Income--Appellate Division Cases (note a)

Dollar amount from source	Compensation		Dividends		Interest		Other	
	No.	Percent	No.	Percent	No.	Percent	No.	Percent
Zero (note b)	1	1.2	61	72.6	34	40.5	48	68.6
Less than $1,000	0	0	21	25.0	46	54.8	11	15.7
$1,000 - $4,999	7	8.3	2	2.4	4	4.8	7	10.0
$5,000 - $9,999	29	34.5	0	0	0	0	2	2.9
$10,000 - $19,999	31	36.9	0	0	0	0	2	2.9
$20,000 - $49,999	15	17.9	0	0	0	0	0	0
$50,000 or more	1	1.2	0	0	0	0	0	0
Total	84	100.0	84	100.0	84	100.1	70	100.1

a/The figures in each colum represent the number and percentage of taxpayers who received the amounts of income shown from the stated sources.

b/Does not include deficit returns. Fourteen taxpayers filed returns showing a net loss from other income sources.

The statutory maximum limit on the amount excludable by nondegree candidates is $10,800 in a period of 36 months. Most nondegree candidates exclude between $1,000 and $5,000 from gross income. Since there is no dollar limit on the amount excludable by a degree candidate, a significant percentage of taxpayers in this category excluded more than $5,000 from gross income. One nondegree candidate attempted to exclude in excess of $20,000 in 1 year. In 13 instances in the sample of 220 Appellate Division returns, and in 8 of the total of 179 section 117 decided cases, both husband and wife, filing joint returns, claimed exclusions for amounts received for research or study.

Income Exclusion--Appellate Division Cases (note a)

Amount excluded on return	Degree student		Nondegree student	
	No.	Percent	No.	Percent
Zero (note b)	3	4.5	0	0
Less than $1,000	0	0	4	3.8
$1,000 - $4,999	50	74.6	94	88.7
$5,000 - $9,999	11	16.4	8	7.5
$10,000 - $19,000	3	4.5	0	0
$20,000 or more	0	0	0	0

Income Exclusion--Decided Cases

Amount excluded on return	Degree student		Nondegree student	
	No.	Percent	No.	Percent
$801 - $1,799	4	7.0	3	2.6
$1,800	0	0	12	10.3
$1,801 - $5,399	22	38.0	73	62.4
$5,400	0	0	4	3.4
$5,401 - $7,199	8	14.0	2	1.7
$7,200	0	0	12	10.3
$7,201 or more	23	40.4	11	9.4

a/The figures in each column represent the number and percentage of taxpayers who received the amounts of income shown from the stated sources.

b/Does not include deficit returns. Fourteen taxpayers filed returns showing a net loss from other income sources.

The sample of Appellate Division cases classified under the section 117 principal issue category shows that deficiencies generated by disallowance of the exclusion for degree students tended to be less than for nondegree students, notwithstanding the dollar limitations on the maximum amount excludable by nondegree students. This result reflects the fact that, on an average, nondegree students were in higher income brackets than degree students. The dollar amount of deficiencies proposed at the District Conference level, compared to that proposed at the Appellate Conference level for the sample of taxpayers contesting deficiencies based on disallowance of an exclusion for amounts received for study or research is summarized below. 1/

Dollar Amount of Proposed Deficiencies Based on Disallowance of Exclusion for Scholarship or Fellowship Grants Appellate Division Cases

	District Director		Appellate Division (note a)	
Degree students	No.	Percent	No.	Percent
Zero	2	3.0	16	24.2
Less than $500	28	41.8	25	37.9
$500 - $999	24	35.8	13	19.7
$1,000 - $4,999	12	17.9	9	13.6
Unknown	1	1.5	3	4.5
Nondegree students				
Zero	3	2.8	9	8.5
Less than $500	31	29.2	33	31.1
$500 - $999	60	56.6	55	51.9
$1,000 - $4,999	12	11.3	7	6.6
Unknown	0	0	2	1.9

a/Does not include one proposed refund.

In the sample of Appellate Division cases, most of the taxpayers who claimed an educational expense deduction reported outlays of between $1,000 and $5,000 for tuition, fees, and books. While the expenses of travel away from

---

1/See app. II for an explanation of the method of calculation of a deficiency based upon disallowance of an income exclusion or deduction from gross income to reach adjusted gross income.

home incurred in order to pursue a deductible education are treated as an "educational expense," we excluded travel expenses in computing the amount of educational expense and resultant proposed deficiency generated by disallowance of a deduction for such expense. In all cases included in the sample, the educational expense deduction was claimed as a miscellaneous itemized deduction which means that it was offset against gross income to reach adjusted gross income and was taken in lieu of the standard deduction or low income allowance. 1/

Educational Expense Deduction
Appellate Division Cases

Amount deducted on return	Number	Percent of sample
Zero	2	2.4
Less than $1,000	27	32.1
$1,000 - $4,999	54	64.3
$5,000 - $9,999	1	1.2
$10,000 or more	0	0

The dollar value of the deficiency generated by disallowance of the educational expense deduction was, in more than 70 percent of the cases covered by the Appellate Division sample, less than $500 and in nearly all cases was less than the dollar value of the proposed deficiency generated by disallowance of an income exclusion of the same amount. This difference is attributable to the fact that, as a rule, disallowance of an itemized deduction generates less revenue than disallowance of an income exclusion because the increase in the net taxable income base resulting from adding back an itemized deduction must be reduced by the standard deduction or low income allowance. 2/ The

---

1/The dollar amount of the educational expense deduction at issue in the decided cases included related travel expenses. In most cases the statement of facts was not sufficiently detailed to permit a separation of the educational expense dollar amount into that amount for tuition, fees, and books and an amount for travel costs.

2/See app. II for an explanation of the method of calculation of a deficiency based upon disallowance of an itemized deduction for educational expenses.

dollar amount of deficiencies proposed at the District Conference level, compared to that proposed at the Appellate Conference level, for the sample of taxpayers contesting deficiencies based on disallowance of a deduction for educational expenses is summarized in the table below.

Dollar Amount of Proposed Deficiencies Based on Disallowance of an Itemized Deduction for Educational Expenses Appellate Division Cases

Amount of proposed deficiency	District Director		Appellate Division	
	No.	Percent	No.	Percent
Zero	a/1	1.2	5	6.0
Less than $500	69	83.1	66	79.5
$500 - $999	10	12.0	6	7.2
$1,000 - $4,999	3	3.6	2	2.4
Unknown	0	0	4	4.8

a/Does not include one proposed refund.

CHAPTER 4

EVALUATION OF THE TAX LAW RULES AS AN AID TO EDUCATION

This chapter is concerned with assessing the use of the tax system to help defray the cost of job-related education. It is assumed that education is a merit want 1/ and that assistance to education, either directly or indirectly through the tax system, is in the public interest. Existing tax rules are not an effective aid to education to the extent that they accord unequal treatment to persons in like financial circumstances.

APPLICATION OF TAX EXPENDITURE THEORY

The exclusion from gross income of amounts received for study, research, or teaching is regarded as a tax expenditure. 2/ The dollar value of the revenue loss attributable to the exclusion is reported annually in the President's tax expenditures budget. 3/ This tax expenditure, or tax

---

1/See Richard A. Musgrave, The Theory of Public Finance (1959), pp. 13-14.

2/A tax expenditure is a tax provision which is regarded as a substitute for a direct appropriation and which, therefore, can be expressed as an alternative to a budget program. The tax expenditure concept was written into the law governing the budgetmaking process by the Congressional Budget and Impoundment Control Act of 1974. The act defines a tax expenditure as a preferential rate of tax, a deferral of tax liability, or an offset against gross income in the form of an exclusion, exemption, deduction, or credit against tax which is "special." Special in this context means that the tax rule is not required to define net taxable income, but is designed to give tax relief in hardship situations or to change the incentive structure in private markets.

3/The official tax expenditures budget is published in Special Analysis G, of the FY 1979 budget of the U.S. Government. For a discussion of the origin of the tax expenditures budget and of the rationale for the list adopted by the U.S. Treasury and House Ways and Means Committee, see Stanley S. Surrey, Pathways to Tax Reform, Harvard University Press (1973).

subsidy, is regarded as the substantial equivalent of a direct subsidy in the dollar amount of the estimated tax savings assigned to the exclusion. That is, the gross amount of the grant is treated conceptually as consisting of two different income sources: (1) the gross amount of income, I, received by the taxpayer, minus the tax that would be paid had the income been included in the tax base, is regarded as received from the actual payor

$$I(1-tx)$$

and (2) the tax not paid is regarded as received by the taxpayer from the Treasury.

$$I(tx)$$

For example, assuming a tax rate of 20 percent, a taxpayer who receives $100 of exempt income is regarded as receiving $80 from the payor $100(1 - .20) and $20 from the Treasury $100(.20).

The deduction from gross income, or adjusted gross income, of job-related educational expenditures is not regarded as a tax expenditure. The deduction is regarded as a "normal" tax computation rule required to determine net taxable income. In the context of the taxability of educational grants and expenses, this distinction is an overly simplistic one. The dollar value of the tax savings attributable to the exclusion from gross income of a scholarship or fellowship grant is precisely the same as the dollar value of the tax savings attributable to deducting educational expenses from gross income to reach adjusted gross income. All that separates these two different forms of offsets is the tax-law concept of "engaged in trade or business." In substance, both offsets are a contribution through the tax system to defray the cost of investing in human capital through education. If, as a matter of public policy, it is worth the loss in tax dollars to defray the costs of education in general through an exclusion for grants received for study, research, or teaching, it should be worth the loss in tax dollars to defray the cost of job-related education through a deduction from gross income for educational expenses.

Taxonomy is not a useful tool of analysis in this situation. In this area of job-related educational grants and expenses, the emphasis on taxonomy at the sacrifice of equity is mischievous and effects grossly unjust results.

We are concerned here with a relatively homogeneous group of taxpayers. The income range of taxpayers who contest deficiencies based upon disallowance of an exclusion for scholarship or fellowship grants and upon disallowance of a deduction for educational expenses is not large. Seventy-five percent of all taxpayers in the sample of Appellate Division cases had adjusted gross income of less than $16,607; 50 percent had adjusted gross income of less than $9,900. Fifty percent had taxable income of $8,745 or less. Thirty-two percent of all taxpayers in the sample of Appellate Division cases fell in the 15- to 20-percent marginal tax rate bracket; 23 percent fell in the 20- to 25-percent bracket; 67 percent were in a 20-percent or less marginal tax bracket.

Thus, there does not exist in acute form the problem of the "upside-down" effect of tax expenditures applicable to taxpayers in a wide income range; namely, that an exclusion or deduction is worth $70 to a taxpayer in a 70-percent marginal tax rate bracket and $20 to a taxpayer in a 20-percent marginal tax rate bracket. Even with respect to the amount of educational assistance excluded from the tax base as compared to the amount of educational costs deducted, there is not a wide variation. As noted in chapter 2, assistance through the tax system is concentrated on the exclusion of educational grants and the $1,000 to $5,000 range. Relatively little tax aid is given to taxpayers who finance their job-related educational costs out of their own funds because in most cases deduction of the expenditure is allowable only if the taxpayer elects to itemize his/her personal deductions.

EXAMPLES OF UNEQUAL TREATMENT OF TAXPAYERS IN LIKE FINANCIAL CIRCUMSTANCES

Hypothetical examples based upon income data descriptive of the "average" or "typical" taxpayer in the Appellate Division sample is used to illustrate the kinds of inequities created by the present section 117 exclusion and 162 deduction rules.

Scholarship or fellowship

Case 1. Consider the case of a taxpayer who qualifies as a degree candidate. He is married and on a joint return reports income and deductions as follows: 1/

Adjusted gross income = gross income		$10,000
Compensation	$10,000	
Scholarship of $4,000	0	
Less: 2 personal exemptions	1,500	
low-income allowance	2,100	3,600
Taxable income		6,400
Tax liability		1,076
After-tax financial resources		$12,924

The tax loss attributable to exclusion of the $4,000 scholarship grant is $801.20--the difference in tax liability of $1,076 and of $1,877.20, which would result if the $4,000 were included in gross income and the percentage standard deduction of $2,240 were taken. 2/

Case 2. The facts are the same as in case 1 except the taxpayer is a nondegree candidate and has not exhausted his 36-month benefit period.

1/The tax computation method applicable for years ending December 31, 1975, is used in order clearly to illustrate the interaction between the deduction, standard deduction, and exclusion rules and to avoid having to make an adjustment for the temporary general tax credit. In cases where the applicable standard deduction is equal to or greater than the zero-bracket amount built into the 1977 tax tables and rate schedules, the final tax liability is the same whether the 1977 tax tables or the statutory rate schedule applicable for tax years ending December 31, 1976, are used. In cases where the low-income allowance applies, or where the percentage standard deduction is lower than the zero-bracket amount, tax liability computed under the 1977 tax tables or rate schedules would be lower. In all cases, final tax liability would be less by the amount of the applicable general tax credit were the tax computation rules for years ending after 1975 applied.

2/Were the 1977 tax table for married persons filing jointly applied, the tax cost attributable to the exclusion would be $727--the difference in tax table liability of $1,492 and $765.

Adjusted gross income = gross income		$10,400
Compensation	$10,000	
Fellowship of $4,000	400	
Less: 2 personal exemptions	1,500	
low-income allowance	2,100	3,600
Taxable income		6,800
Tax liability		1,152
After-tax financial resources		$12,848

The tax loss attributable to exclusion of $3,600 of the $4,000 fellowship grant is $725.20--the difference in tax liability between including and excluding $3,600 in adjusted gross income. 1/

Educational expenses

Case 3. 2/ Taxpayer has a full-time job and, in addition, attends classes in the evenings and on Saturdays. The courses are related to his employment and expenses for tuition, books, and fees are an allowable deduction. Taxpayer is married and on a joint return reports income and deductions as follows:

Adjusted gross income = gross income		$10,000
Less: 2 personal exemptions	$1,500	
educational expenses	4,000	5,500
Taxable income		4,500
Tax liability		715 3/
After-tax financial resources		$ 9,285

1/Were the 1977 tax table for married persons filing jointly applied, the tax cost attributable to the exclusion would be $659, the difference in tax table liability of $1,492 and $833.

2/The facts in case 3 apply also to employees enrolled in a work training program such as that conducted by the General Motors Corporation in cooperation with the General Motors Institute. Under this program, the employees work for 6 months and go to school full time for 6 months. They receive a salary while employed, but pay and deduct their educational expenses. Victor Ide, et. al., 73-2 U.S.T.C. Par. 9553 (D.C. Mich., 1973).

3/The 1977 tax table liability would be $535.

The tax loss attributable to deduction of the $4,000 of educational expenses is $361--the difference in tax liability between claiming the low income allowance of $2,100 and deducting $4,000. 1/

Case 4. The facts are the same as in case 3 except the taxpayer is self-employed.

Gross income		$10,000
Less: educational expenses		4,000
Adjusted gross income		6,000
Less: 2 personal exemptions	$1,500	
low-income allowance	2,100	3,600
Taxable income		2,400
Tax liability		354
After-tax financial resources		$9,646

The tax loss attributable to deduction of the $4,000 of educational expenses is $722--the difference in tax liability between not deducting the $4,000 from gross income and deducting it. 2/

Reimbursement

Case 5. The facts are the same as in case 3 except the taxpayer receives $4,000 from his employer as reimbursement for educational expenses incurred for courses related to the taxpayer's employment. The amount received as tuition reimbursement is not excludable from gross income under section 117. 3/ It is deductible from gross income as a reimbursed

---

1/Were the 1977 tax table for married persons filing jointly applied, the tax cost attributable to the deduction would be $230--difference in tax liability attributable to the zero-bracket amount of $3,200 and the $4,000 deduction.

2/Were the 1977 tax table for married persons filing jointly applied, the tax cost attributable to the deduction would be $646--the difference in tax table liability for tax table income of $10,000 and tax table income of $6,000.

3/Rev. Rul. 76-62, 1976-1 C.B. 12.

employee trade or business expense if the educational expenses would be deductible if paid out of the employee's own funds, 1/ or if the tuition were paid directly to the school. 2/

Gross income		$14,000
Less: tuition reimbursement		4,000
Adjusted gross income		10,000
Less: 2 personal exemptions	$1,500	
low-income allowance	2,100	3,600
Taxable income		6,400
Tax liability		1,076 3/
After-tax resources		$12,924

The implication of the regulations is that including the $4,000 educational expense reimbursement in gross income and then deducting it out again under section 162(a) results in a wash. This is correct. It places the employee who is reimbursed for his educational costs in the same position taxwise as the self-employed person who finances and deducts the costs of his job-related education and as the recipient of an excludable scholarship or fellowship grant (case 1). By deducting the educational expenses from adjusted gross income and electing the low-income allowance, the employee who is reimbursed pays only $361 more in taxes than does the employee who is not reimbursed and deducts the cost of financing his job-related education out of his own funds (case 3). 4/

Case 6. The facts are the same as in case 3 except taxpayer receives $2,000 from his employer as reimbursement for $4,000 of educational expenses related to the taxpayer's employment. The excess of the expenditure over the reimbursement is deductible only if the taxpayer elects to itemize

---

1/Regulations section 1.162-17(b)(1); Rev. Rul. 76-71, 1976-1 C.B. 308; Rev. Rul. 60-97, 1960-1 C.B. 69, 75. David E. Mark, 26 T.C.M. 1106 (1967).

2/Rev. Rul. 76-65, 1976-1 C.B. 46.

3/1977 tax table liability would be $765.

4/In this case were the 1977 tax rates for married persons filing jointly applied, the employee who is reimbursed would pay only $50 more in taxes than would the employee who is not reimbursed.

his personal deductions. 1/ In this case since the low-income allowance is $100 more than the $2,000 educational expense deduction for the unreimbursed portion of the taxpayer's costs, the taxpayer, in effect, loses the tax benefit of the educational expense deduction.

Gross income		$12,000	
Less: tuition reimbursement		2,000	
Adjusted gross income		10,000	
Less: 2 personal exemptions	$1,500		
low-income allowance	2,100	3,600	
Taxable income		6,400	
Tax liability		1,076	2/
After-tax financial resources		$10,924	

Case 7. The facts are the same as in case 3 except the educational expenses for which the taxpayer is reimbursed by his employer are not required by the employer to be job related. Assume that the courses meet the requirements of regulations section 1.162-5. The reimbursement is includable in income; the expenses are deductible from adjusted gross income. 3/

Adjusted gross income = gross income			$14,000	
Compensation	$10,000			
Reimbursement	4,000			
Less: 2 personal exemptions		$1,500		
educational expenses		4,000	5,500	
Taxable income			8,500	
Tax liability			1,490	4/
After-tax resources			$12,510	

1/Rev. Rul. 60-97, 1960-1 C.B. 69, 75.

2/1977 tax table liability would be $765.

3/Bingler v. Johnson 394 U.S. 741 footnote 9, at 744 (1969); Rev. Rul. 76-352, 1976-2 C.B. 37. If the courses are not job related, the reimbursement is includable in gross income and the expenses are not deductible. Rev. Rul. 76-62, 1976-1 C.B. 12.

4/1977 tax table liability would be $1,310.

The tax loss attributable to deduction of the $4,000 of educational expenses is $397.20--the difference in tax liability of $1,490 if the $4,000 is taken as an itemized deduction and the tax liability of $1,887.20 which would result if the percentage standard deduction, of $2,240 were taken. 1/

Case 8. The facts are the same as in case 3 except the taxpayer is a veteran and receives $4,000 in educational benefits from the Veterans Administration excludable from gross income. 2/ The taxpayer incurs $4,000 of job-related educational expenses, which qualify for deductions under regulations section 1.162-5.

Adjusted gross income		$10,000
Less: 2 personal exemptions	$1,500	
educational expenses	4,000	5,500
Taxable income		4,500
Tax liability		715
After-tax financial resources		$13,285

The tax loss attributable to the $4,000 exclusion plus deduction of the $4,000 educational expense is $1,162--the difference in tax liability between including and excluding the $4,000 in gross income and between claiming a standard deduction of $2,240 and deducting $4,000. 3/

Case 9. Finally, there is the situation of the taxpayer who does not qualify for a scholarship and who therefore pays his own tuition and related educational expenses out of income earned as a researcher in the department where he is a degree candidate. The compensation is not excludable under section 117 4/ and the educational expenses are not deductible under

---

1/Were the 1977 tax table for married persons filing jointly applied, the tax cost attributable to the deduction would be $182--the difference in tax liability attributable to the zero-bracket amount of $3,200 and the $4,000 itemized deduction.

2/Rev. Rul. 62-213, 1962-2 C.B. 59.

3/Were the 1977 tax rates for married persons filing jointly applied the tax cost attributable to the $4,000 exclusion plus the $4,000 deduction would be $777--the difference in tax table liability of $1,492 and tax table liability of $715.

4/Stephen L. Zolnay, 49 T.C. 389 (1968).

section 162 if the taxpayer is not engaged in a trade or business or if the educational experience trains the taxpayer for a new field. [1]

Adjusted gross income		$10,000
Less: 2 personal exemptions	$1,500	
low-income allowance	2,100	3,600
Taxable income		6,400
Tax liability		1,076 [2]
After-tax resources		$8,924

The results of the rules illustrated by the nine examples based on individuals filing a joint return and with gross income (excluding scholarship or fellowship money) of $10,000 may be summarized as follows:

Income or expense item	Tax saving attributable to exclusion and/or deduction 1975 tax rules	1977 tax rules
1. $4,000 grant excluded; take low-income allowance	$801	$727
2. $3,600 of the $4,000 grant excluded; take low-income allowance	725	659
3. No grant; $4,000 expense deducted from AGI	715	535
4. No grant; $4,000 expense deducted from GI; take low-increase allowance	722	646
5. $4,000 reimbursement included; $4,000 expense deducted from GI; take low-income allowance	801	727
6. $2,000 reimbursement included; $2,000 expense deducted from GI; take low-income allowance	801	727
7. $4,000 reimbursement included; $4,000 expense deducted from AGI	397	182
8. $4,000 reimbursement excluded; $4,000 expense deducted from AGI	1,162	777
9. No grant; take low-income allowance	0	0

---

[1] Leonard T. Fielding, 57 T.C. 761 (1972).

[2] 1977 tax table liability would be $765.

CONCLUSION

By elevating legal form over economic substance, the tax rules have effectively constructed a disincentive system for the industrious student who finances his education out of his own funds. The differences in results in these nine cases cannot be justified either on equity or incentive grounds. They come about not because an explicit policy decision has been made to favor individuals who receive financial assistance for their study or research over individuals who finance their educational costs out of their own funds or to favor self-employed individuals over employees. The factors of the artificial distinction between degree and nondegree candidates of section 117, the preoccupation of the regulations with niceties of refining the definition of net taxable income, the interaction of sections 162 and 117 with the percentage standard deduction and the low-income allowance, or with the zero-bracket amount of the 1977 tax schedules and tables all combine to create an incentive structure which is both perverse and grossly unfair.

The exclusion of scholarships and fellowships prefers "grant" income to the earnings of students who work their way through school--whether at the graduate or the undergraduate level. The liberal treatment of educational expenses for persons engaged in teaching and related fields contrasts with the restrictive rules applicable to employees undertaking legal education to advance themselves with their present employers. The volume of litigation generated by these tax rules indicated that the administrative cost of enforcement may be disproportionate to the amount of assistance given through the tax system.

Because, in theory, the recipient of a grant for study or research is regarded as receiving a tax subsidy in the amount of the tax saving generated by the income exclusion, the taxpayers in cases 1 and 2 are regarded as having received tax subsidies from the Treasury. Again, in theory, because the taxpayers in cases 3, 4, and 5 are regarded as having incurred ordinary and necessary expenses to create taxable income, the tax saving generated by the educational expense deduction is not regarded as a tax subsidy. It hardly needs to be said that the name given to a tax saving does not affect its dollar value.

Evidence generated by the sample of taxpayers contesting educational tax deficiencies before the Appellate Division and by the decided cases suggests that whether or not allowance of a deduction for job-related educational expenses is denominated a tax expenditure, equity would be served by allowing such a deduction as an offset against gross income to reach adjusted gross income. It follows that if the educational costs financed by an exempt grant were deductible from gross income, there would be little advantage to retaining the income exclusion in the law.

CHAPTER 5

OVERALL CONCLUSIONS, RECOMMENDATIONS, AND TREASURY'S POSITION

CONCLUSIONS

The statutory exclusion of scholarships and fellowships has created a privileged income source for a relatively small number of people engaged in studying, doing research, and working in schools, hospitals, libraries, or museums. The exclusion may apply also to travel grants in circumstances where travel is regarded as a form of education.

The limited deduction allowed by the regulations for educational costs incurred to maintain existing job skills, combined with the disallowance of a deduction for educational costs incurred either to meet minimum job requirements or to qualify for a new job or job promotion in the same general line of business, has created a privileged use of funds by persons engaged in the teaching profession with no comparable advantage extended to persons employed in accounting, law, and other business-related professions.

The effect of the interaction between the statutory exclusion and the administrative deduction provision is to favor individuals who receive financial assistance or are reimbursed for job-related study or research over individuals who finance job-related educational costs out of their own after-tax earnings. The effect of the interaction between the administrative deduction provision and the standard deduction is to favor the self-employed person who finances the cost of his education out of his earnings over the employee who finances his education out of after-tax wages.

Educational grants

The proposed amendment to the statutory exclusion provision of section 117 removes the distinction made by present law between degree and nondegree candidates. This distinction has the effect of exempting from tax some kinds of education-related earned income received by degree candidates. The precise limit of this statutory exemption has been a source of endless controversy because the favorable tax treatment of degree students is perceived by nondegree students as being unfair.

Under the proposed amendment, no amount received as a scholarship or fellowship is excludable if the element of compensation is present to any extent. That is, by definition, if there exists an employment or independent contractor relationship between the grantor and the student, job trainee, teaching assistant, or medical intern, any stipend, grant, or other amount received will not qualify as an excludable scholarship or fellowship. For this purpose, it is irrelevant whether the recipient is matriculated at an educational organization as a degree or as a nondegree student.

Further, the proposed amendment to section 117 extends to all recipients of educational grants the limitation of existing law on the category of entities which can qualify as grantors of exempt scholarships and fellowship awards to nondegree candidates.

Under the proposed amendment the grantor must be either an exempt nonprofit organization described in section 501(c)(3) or a governmental organization. This rules out for exclusion educational grants and other forms of financial assistance extended by profit corporations and other private, taxable entities to the dependents of employees. Such grants are additional compensation in the form of a fringe benefit. This also rules out for exclusion as a scholarship or fellowship corporation grants to persons who have no employment relationship with the grantor, either directly or indirectly as the dependent of an employee. Such grants are includable in gross income unless they can qualify as a prize, award, or gift. At the corporate level such grants might be deductible as an advertising or promotional expense.

We have extended the limitation of present section 117(b)(2)(A) to degree candidates because the matriculation status of a student is in many cases a technical relationship which can be easily manipulated to achieve a "right" tax result and because we wished to restrict the class of grantors which can make excludable educational grants to nonprofit organizations, including governmental agencies, in the business of making educational grants on the basis of scholastic merit, recognized achievement, and/or financial need.

The proposed amendment makes irrelevant the "primary purpose" test of Bingler v. Johnson 394 U.S. 741 (1969) by writing into the law a statutory definition of excludable scholarship or fellowship grant in terms of the uses to which the funds can be put. An educational grant received from a qualified donor for study at a facultied educational organization is includable in income to the extent the funds are not spent for tuition, meals, and lodging in the school dormitory or school approved housing accommodation, and for travel required to relocate on school premises and to return home during vacations.

An educational grant used to finance the cost of travel as education does not quality as an exempt grant under the proposed amendment for two reasons: (1) the grant is not for study or research at a facultied educational organization and (2) it is not spent on tuition, meals and lodging, and incidental travel expenses. The exclusion of the travel grant from the category of qualified exempt educational grants is based on two considerations: (1) travel regarded as education is essentially a consumption expenditure or a personal investment in an enhanced quality of life; the educational value of travel is not limited to members of the teaching profession and (2) inclusion in income of a travel grant received by a person for whom travel is an independent income-generating activity (e.g., author, travel agent, lecturer) works no hardship since the costs incurred in this case would be an allowable business expense deduction from gross income to reach adjusted gross income.

Educational expenses

The proposed addition of new section 192 to the code and the proposed amendment of section 62 to add a new subparagraph (14) make uniform the tax treatment of all persons who incur job-related educational expenses. New section 192 removes the distinction made by regulations section 1.162-5 between (1) ordinary business expenses incurred to maintain or improve skills required by the job or to meet the express requirements of the job and (2) capital or combined capital-personal expenses incurred to meet the minimum educational requirements of the job or to qualify for a new trade or business. New subparagraph (14) treats job-related educational expenses which qualify for deduction under new section 192 as an offset against gross income to reach adjusted gross income. This makes the deduction available to taxpayers who elect the standard deduction.

Our study of the educational expense deduction cases, both contested proposed deficiencies pending in the Appellate Division and cases litigated through to a final decision during the last 10 years, shows that the distinction made by regulations section 1.162-5 between job-related educational expenses that are ordinary in nature and those that are capital or "combined capital-personal" in nature is confusing and difficult for most people to understand. We found that

80

this concept, which underlies the distinction made by the regulations between job-maintenance educational costs and job-qualification or job-enhancement educational costs, was the principal source of controversy in the educational expense area.

The problem is that application of the capital expense concept to expenditures made by a natural person for his own benefit does not correspond with the sense of the everyday use of the notion of capital investment. Furthermore, the concept is irrelevant in the context of a personal income tax based upon ability to pay. The value of the individual, himself, considered as an income-generating, depreciable capital asset is a relevant concept for national income accounting purposes where the object is to measure the effect of outlays for education, training, health care, and mobility on economic growth. It may have some bearing on the measurement of earned income under a schedular income tax system where different rates and tax-calculation rules apply to each separate income source, and where the income source, not the individual taxpayer, is regarded as the subject of the tax. The concept of the individual as a depreciable capital asset (i.e., of investments in human capital as capable of creating a separate amortizable asset) has no bearing on the definition of net income where the object of the definition is to measure financial capacity to pay a tax currently.

Under a personal income tax based on ability to pay, any investment which an individual makes in his education can only be either personal (consumption) in nature or business related.

The proposed new section 192 focuses on the issue of the deductibility of job-related education expenses. The expense is deductible if it qualifies as an "ordinary and necessary business expense" under existing case law and administrative ruling criteria. The "in connection" phrase does not establish a new or additional test of deductibility.

The kinds of educational expenses which qualify for deduction under new section 192 include some of the same kinds of direct educational expenses which may qualify an educational grant for exclusion: tuition, books and equipment, and clerical assistance. Travel, meals, and lodging, incidental to job-related education, remain deductible as a separate travel expense under section 162(a)(2). The person who qualifies for the educational expense deduction is a person whose activities generate taxable earned income, whether as an employee or as an independent contractor. For this purpose, earned income has the same meaning as it does under section 911, relating to the exclusion of certain foreign source earned income of nonresident citizens.

Finally, the difference in treatment under existing law depending upon whether the taxpayer is an employee or a self-employed person is removed by making the educational expense deduction an offset against gross income to reach adjusted gross income. While we did not find that the technical interaction of the itemized educational expense deduction with the standard deduction was a source of controversy, on its face it is evident that this relationship results in a difference in tax liability which does not reflect a difference in economic circumstance. There is no reason to perpetuate this unfair result.

Combined effect of the proposed amendments

The combined effect of restricting the income exclusion of amounts received for study and research and of liberalizing the deduction for job-related educational expenses is (1) to remove the difference in treatment which exists under present tax-law rules between those who receive financial assistance for job-related education and those who finance job-related education out of their own after-tax earnings and (2) to treat educational grants and expenses in an obvious way so that general rules can be made to apply without creating inequitable discontinuities.

These proposed amendments do not cover educational expenses incurred by parents, guardians, or relatives for the benefit of dependent students. The economic burden of the costs of post-secondary education imposed on taxpayers who finance the education of a dependent child is a separate and unrelated problem which is outside the scope of this study. The dependent student is essentially a consumption item for the parent or guardian who assumes financial responsibility for the education of the dependent as additional support. In this context, costs incurred on behalf of the student before he has assumed the economic status of a self-supporting, tax-paying member of society are personal, "preparation-for-life expenditures." The situation is not altered by the fact that the student may take summer jobs, work part time during the year, or even borrow the money and repay it out of earnings received after he has become an independent and self-supporting worker.

Basically, the proposed amendments are designed to cover two issues--both of which we found to be a principal source of IRS-taxpayer controversy and productive of serious inequity:

--The tax status of compensation received in the guise of an educational grant or payment for learning by doing.

--The tax status of job-related educational expenses incurred for training which does something more than to barely maintain the skills which the employee must have in order to hold his job.

RECOMMENDATIONS TO THE CONGRESS

We recommend that section 117 of the Internal Revenue Code, relating to the scholarship and fellowship exclusions, be amended as follows:

Section 117. Scholarships and Fellowships

(a) General rule--Except as provided in subsection (b), gross income includes amounts received as scholarship and fellowship grants.

(b) Exception--Gross income does not include amounts received as a scholarship or fellowship grant to do study or research at an educational organization described in section 170(b)(1)(A)(ii) if

(1) the amount received is limited to the cost of--

(A) tuition,

(B) meals, lodging, and travel,

(C) books and equipment,

(D) clerical help,

which are incident to such study or research;

(2) the recipient is selected on the basis of scholastic merit, achievement, or financial need;

(3) the recipient is not required to render present or future services as a condition to receiving the scholarship or fellowship grant;

(4) the amount received does not represent compensation for services performed in the past; and

(5) the grantor of the scholarship or fellowship grant is

(A) an organization described in section 501(c)(3), which is exempt from tax under section 501(a),

(B) a foreign government,

(C) an international organization or a binational or multinational educational and cultural foundation or commission created or continued pursuant to the Mutual Educational and Cultural Exchange Act of 1961, or

(D) the United States, or an instrumentality or agency thereof, or a State, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(c) Regulations--The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section.

We recommend that the following amendments be made to the Internal Revenue Code relating to job-related educational expense deductions.

Section 62. Adjusted Gross Income Defined

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

* * * * *

(14) Education expenses--The deduction allowed by section 192.

Section 192. Education Expenses

(a) Deduction allowed--There shall be allowed as a deduction education expenses paid or incurred during the taxable year

(1) in connection with a trade or business of the taxpayer as a self-employed individual or

(2) in connection with the trade or business of the taxpayer as an employee.

(b) Definition of education expenses--For purposes of this section, the term "education expenses" means only the expenses paid or incurred by the taxpayer for

(1) tuition at an educational organization described in section 170(b)(1)(A)(ii),

(2) books and equipment, and

(3) clerical help

which are incident to the course of study for which the taxpayer is enrolled.

(c) Definition of self-employed individuals--For purposes of this section, the term "self-employed individual" means an individual who receives gross earned income from the performance of personal services

(1) as the owner of the entire interest in an unincorporated trade or business,

(2) as a partner in a partnership carrying on a trade or business, or

(3) as an independent commission agent or broker.

(d) Regulations--The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section.

TREASURY COMMENTS AND OUR EVALUATION

The Assistant Secretary for Tax Policy and Commissioner of Internal Revenue commented on our report in a joint letter of July 21, 1978. (See app. I.)

The Department agreed that section 117 of the Code and section 1.162-5 of the Income Tax Regulations have been difficult to administer and have given rise to a significant amount of controversy. The Department, however, does not believe our specific legislative recommendations would "substantially simplify these areas," or that the legislative recommendations are based on the findings of our work.

Our analysis of cases decided under section 117 shows that most cases concern resident physicians and graduate teaching fellows who seek to exclude from income compensation received for caring for hospitalized patients, for teaching undergraduate college students, or for doing research. Our analysis of cases decided under regulations section 1.162-5 shows that most of the cases concern persons employed as teachers, or in business or government who seek to deduct expenses incurred for advanced education or for travel related to their jobs.

In chapter 4 we discuss the many discontinuities created by the interaction of the section 117 exclusion with the section 162 deduction provisions in different factual circumstances. Our recommended amendments are designed to eliminate these discontinuities by treating persons similarly situated in a like manner--and at the same time removing from the tax law the two legal issues which our study shows are a principal source of IRS-taxpayer dispute.

--The statutory distinction between an exempt scholarship or fellowship grant and taxable compensation.

--The distinction between educational expenditures which are "combined personal or capital" in nature and those which qualify as "ordinary business expenses" under the regulations.

Obviously, as long as the section 117 exemption provision remains in the Code, even in the limited form that we recommend, it will be a source of some controversy by persons who seek to misapply its rules and are picked up on audit. Similarly, as long as job-related educational expenses are deductible to any extent, there will be those taxpayers who will attempt artificially to cast in the business mold expenditures which are essentially personal or consumptive in nature.

IRS-taxpayer disputes can never be eliminated altogether under an income tax system which allows final tax liability to vary among individuals having the same gross income but different "abilities to pay," depending upon the source of spendable funds (compensation, gift, capital gain, etc.) and the use to which such funds are put (health care, education, interest payments, etc.). The most that can be done is to define narrowly and precisely the privileged income source (scholarships and fellowships) and the favored use of taxable income (to defray the cost of job-related education).

The Department stated further that our conclusions

> "* * * could well support a fresh review of the entire area encompassed by Code section 117 and Regulations section 1.162-5 and the alternative solutions could profitably be explored before final publication of your Report."

Our purpose in doing this work was to take a fresh look at the area. Before releasing our draft report for review, we considered the alternative solutions suggested by Treasury, but rejected them as impractical.

Our approach was to take the public policy underlying the existing statutory exemption and deduction rules as given, and then, as a "second best solution," to remove from the Code and the Treasury regulations those specific rules which, on the basis of our study, appeared either to be a principal source of controversy and/or appeared to bring about the undesirable result of treating persons similarly situated in a dissimilar manner.

We adopted this approach for two reasons:

--Outright repeal of the section 117 exclusion could put colleges and universities in the position of having to withhold tax on noncompensatory grants received by taxpayers whose income from all sources is less than the minimum exempt amount. This would create a problem of overwithholding and add to the administrative burden of making tax refunds. Further, an educational grant applied to the costs of tuition, housing, and other direct educational costs does not increase taxpaying capacity currently.

--Outright repeal of the deduction for job-related educational expenses, when combined with the taxation of educational grants received from an employer, would impose an unfair tax burden on employees whose job-related education is financed by the employer. In this circumstance, inclusion of the grant in gross income and deduction out again from gross income to reach adjusted gross income results in a wash.

By not opting for outright repeal of the exclusion and deduction provisions, we have left in the law two issues of ultimate fact which may be a continuing source of IRS-taxpayer controversy:

--The tax status of nonqualified scholarships and fellowships received in circumstances where the compensation element is not present.

--The distinction between educational expenses which are business related and those which are consumptive in nature.

In our view, these two definitional problems are not solvable under an income tax system which requires that a distinction be made between (1) receipts which are "gifts" and receipts which represent some form of payment for purposes of excluding the former from the taxable income base and (2) consumption expenditures and business outlays for purposes of defining net taxable income. A thoroughly precise distinction between donative and nondonative educational grants or between personal and business educational expenses is inconceivable and inadvisable. To write endless detail into the law would merely delineate a "safe haven" area of abuse of the specific rules.

Treasury set forth several alternatives which we discuss below.

Under our legislative recommendation regarding section 117, there would be excluded from the category of exempt educational grants any payment motivated by an employment relationship. By definition, a nonqualified grantor or grantor who stands in an employment relationship to the grantee lacks donative capacity. No provision is made for allocating the total amount received between exempt grant and taxable compensation. Treasury characterizes the proposed rule as a "harsh" result.

It can never be a harsh result under a personal income tax system, based upon ability to pay, to tax an amount received in excess of the minimum amount of exempt income, where the compensation element is present to any extent.

Rather, it is a windfall gain, and also an opportunity for fraud, to characterize as a nonincome receipt (gift, prize, award, grant, etc.) any amount received where the element of payment for personal services is present.

The "related equally difficult" problem referred to by Treasury concerns scholarships awarded by employers to dependents of their employees. We have covered this problem by narrowly defining the category of entities that can qualify as grantors of exempt educational grants. We question whether it is fair or equitable to permit the tax system to be used to subsidize the employee who receives compensation in the form of an educational expense allowance for his dependent. The receipt of this form of in-kind wage income is a fringe benefit and should be taxable as additional compensation quite as much as is the personal use of a company automobile. If the dependent child of the employee merits a scholarship either on the grounds of scholastic merit, achievement, or financial need, he is free to apply for a scholarship to an educational organization or governmental agency, as defined in the proposed amendment to section 117, and to compete with his peers for tax-free assistance. Likewise, if the company wishes to assist meritorious and/or needy students, it is free to donate funds to an educational organization set up to administer the distribution of funds on an impartial basis and in accordance with criteria announced in advance.

Under our legislative recommendation regarding section 117, no amount received from a qualified grantor for travel as education, or for independent study at home or in libraries, museums, or other educational organizations not affiliated with facultied educational organizations would qualify for exclusion. Travel to locate at a qualified educational organization would be excludable. Treasury comments that by thus narrowly defining the scope of activity which qualifies for tax-free support, we have biased the exclusion against independent travel and study. This was our intention based on our findings that this area was being abused. The exclusion for educational grants creates a privileged source of income for a select group of persons who engage in privileged activities. It has the effect of exempting from tax persons who may have the same financial capacity to pay a tax as persons employed in offices and factories at a wage income equivalent in before-tax dollars to the amount of the exempt educational grant. All positive human endeavor makes a contribution to social well-being. Tax laws which single out for special treatment only one form of effort, educational endeavor, should be narrow in scope.

Our proposed amendment limits excludable educational grants to those offered by government entities or exempt organizations under section 501(c)(3) whether or not these organizations qualify as educational organizations under section 170(b)(1)(A)(ii). Treasury states that denying an exclusion for grants from nonexempt, nongovernmental grantors would not "seem significantly to alleviate the problem of identifying grants that represent compensation for services, and it is not clear to us what other policy this limitation serves."

The policy served by this limitation has nothing to do with the question of identifying grants which represent disguised compensation. Under our proposed amendment, an educational grant made by a government agency to an employee is equally taxable as a grant made by a private company to an employee. The policy served by the limitation is that of restricting the grantor of a scholarship which may qualify for exclusion (provided also that the compensation element is not present) to organizations, including governmental agencies, in the business of making educational grants to persons other than employees on the basis of scholastic merit, achievement, and/or financial need.

The proposed amendment to section 117 would not disqualify a grant based on "leadership or similar non-'scholastic' achievements." The criteria of scholastic merit, achievement, or financial need is phrased in the disjunctive. The adjective scholastic modifies merit; no adjective modifies achievement. Further, under our proposed amendment to section 117, if the noncompensatory grant is made on the basis of financial need, it would be exempt, given that the grantor is qualified. The standard of financial need is, at least on its face, fairer than a standard based on disadvantaged minority groups. Furthermore, in some circumstances, so-called majority groups may be quite as disadvantaged as minority groups.

Under the general comments applicable to the proposed amendment to section 117, Treasury recommended that consideration be given to three alternative approaches.

The section 117 exclusion could be limited to tuition and fees. We originally considered limiting the exclusion but rejected the idea on the grounds that complete scholarships and fellowships frequently cover all billable expenses without specific allocation between tuition and costs for board and room either on campus or in university sponsored or approved housing. Making an allocation in this circumstance would impose an administrative burden on the grantor with no discernible benefit taxwise. As pointed out, the revenue significance is negligible or nonexistent of separating the tuition cost from the living expense cost for a full-time student matriculated at a facultied educational organization.

The exclusion could be limited to degree candidates. We considered this alternative but rejected it for the reason that one's status as a degree or nondegree student is largely a formal matter of registration and can easily be manipulated to obtain the "right" tax result. Neither tax equity nor administrative feasibility is served by a rule which would penalize the nondegree student who determines after a period of study to work toward a formal degree and rewards the degree student who, after a period of study, decides to drop out of school without completing the required course of study.

The controversy under existing law with respect to the status of taxpayer as a degree or nondegree student stems principally from the fact that degree candidates can exclude certain compensatory payments whereas nondegree students cannot. Eliminating the exclusion for nondegree candidates would not eliminate controversy; it would merely change the form of the argument as taxable nondegree students continue to seek to place themselves in the privileged degree category. Further, it does not appear fair to place in the taxable category, by definition, postdoctoral research grants where no compensation element exist.

The exclusion could be subject to a dollar ceiling. We considered, but rejected, this possible alternative for the reason that educational costs have escalated so rapidly during the past 10 years that any dollar figure written into the law would soon be made obsolete by inflation and hence defeat the purpose of the exclusion. Further, we did not find that the dollar amount of the exclusion was a source of abuse except in the case of amounts which were, in fact, disguised compensation. Since under our proposed amendment educational grants would not qualify for exclusion if there is present any element of compensation, there is no practical need for a dollar exclusion.

In summary, our legislative recommendation with respect to the exclusion of educational grants is designed to restrict as much as possible, short of outright repeal, a tax-law rule which, in essence, creates a privileged income source. In our view it is unfair and hence provocative of tax controversy, to subsidize through the tax system, the school teacher who travels, the graduate student who teaches, the medical intern who works in a hospital, and to tax at full rates persons gainfully employed in other occupations. Everyone learns through travel, through study in libraries, as well as through work and study on the job.

Our response follows regarding Treasury's specific comments about our proposed amendments to regulations section 1.162-5.

Treasury states that our draft report "recognizes but does not explore in detail--the extent to which" educational expenses should be deducted and, if deductible, whether they should be deducted currently or capitalized and recovered by amortization. Our legislative recommendation would allow a business expense deduction for education expenses paid or incurred "in connection with" the trade or business of the taxpayer. It would eliminate the area of controversy created by the misapplication of the capital asset concept to outlays which represent an investment in human capital employed in paid productive activity. Natural persons are the subject of the personal income tax, not the object. The concept of investment in human capital is irrelevant for income measurement purposes, although useful for national income accounting purposes where the object is to measure economic growth. Under the present regulations, the capital, noncapital expenditure criterion is applied to distinquish between those business-related educational outlays which represent skill maintenance expenditures and those which represent either skill acquisition or enhancement expenditures. The result is to disallow a deduction currently for most business-related educational expenses incurred by business and professional persons. Under the regulations, as a practical matter, only teachers can successfully maintain that study and travel maintains their teaching skills but does not qualify them either for their present position or for an advance. In effect, the regulations define the entire teaching profession as a single line of business whereas the business-related professions are segmented into law, accounting, business administration, etc. This, of course, is at complete variance with the fact that law as a separate profession is shrinking, whereas law as an adjunct to business and accounting is a rapidly expanding area of opportunity.

In our view, no public policy goal is served by allowing a deduction for educational expenses incurred to maintain a skill (business expense) and disallowing a deduction for learning a new skill (combined personal-capital expense). Insofar as there is a public policy goal to be served by allowing a deduction for job-related educational expenses in any amount, it is the goal of increasing labor productivity in employment for which there is a demand. In this context, the correct criterion is not the combined personal-capital versus ordinary business dichotomy of the existing regulations, but the consumption versus ordinary business dichotomy of section 162 and of our proposed amendment.

The distinction between consumption activities and income-generating activities is a familiar one under the income tax. It underlies the itemized deduction provisions, the allowance of section 212 expenses, and the ordinary and necessary criterion of the business expense deduction provisions. It properly should underly any deduction provision which makes a distinction between business (deductible) and personal (nondeductible) educational expenses. Although this distinction is a familiar tax concept, it is impossible to draw a thoroughly precise and objective distinction between personal and business outlays, either in general or for educational expenses in particular. Further, in our view it is inadvisable to attempt any "bright-line" distinctions. The likely result of such an effort would be to spell out an area of "safe-haven" conduct.

Treasury states further that the proposed legislative change:

> "Would continue to place at a tax disadvantage by far the majority of students who pursue their education on a full-time basis before they enter the job market at all. The education of such individuals would continue to be financed with after-tax dollars."

There is a fundamental difference in economic circumstances between the dependent child whose "preparation-for-life" study is financed by a parent or guardian at a time when the child has not yet become a productive, self-supporting and taxpaying member of society and the adult, self-supporting employed person who finances education undertaken to advance himself in his employment as distinguished from education as recreation. There is nothing "unfair" about disallowing a business expense deduction for educational expenses incurred by or on behalf of "those who attend school full-time before entering the job market." Since presumably this category of student earns little or no income and pays little or no tax, the only tax advantage that could be created by the deduction would be at the level of the parent or guardian for whom the dependent is a consumption item and who finances the education of the dependent student as additional support. The issue of the tax status of personal expenses incurred to finance the education of a dependent is altogether unrelated to that of the deductibility of job-related educational expenses incurred by persons who have assumed responsibility for their own financial support.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JUL 21 1978

Mr. Victor L. Lowe
Director
General Government Division
General Accounting Office
Washington, DC 20548

Dear Mr. Lowe:

In response to your letter of May 2, 1978, we are writing jointly to convey to you the views of the Internal Revenue Service and the Department of Treasury on a draft report entitled "An Analysis of the Tax Law Rules Governing the Exclusion for Scholarships and Fellowships and the Deduction of the Job Related Educational Expenses" (the "Draft Report").

As the Draft Report suggests, section 117 of the Code and section 1.162-5 of the Income Tax Regulations have been difficult to administer and have given rise to a significant amount of controversy. The Draft Report identifies several apparent reasons for this situation. However, the Draft Report does not seem to base its legislative recommendations on these findings and we do not believe the specific language of the legislative recommendations would substantially simplify these areas. We believe your conclusions could well support a fresh review of the entire area encompassed by Code section 117 and Regulations section 1.162-5 and that alternative solutions could profitably be explored before final publication of your Report.

It is important to recognize that proposals drawing "bright line" distinctions that eliminate controversy and are easy to administer may in some cases be less equitable than more subjective flexible tests. Though we would favor increased simplification, we believe that any changes in existing law should be carefully examined from the point of view of equity as well. We will suggest below some alternatives that might be considered. These suggestions are intended to indicate a range of possible approaches for discussion and do not reflect the formal views of either Treasury or the Service as to whether revisions would ultimately be appropriate.

I. Code Section 117 Exclusion for Scholarships and Fellowships

The Draft Report concludes that the structure of section 117 is confusing largely because the law does not define a "scholarship" or a "fellowship" except through limitations, including a denial of the exclusion for certain compensatory payments. Much of the controversy under present law deals with distinguishing between excludable amounts and taxable compensatory payments.

The Draft Report proposes legislation that would exclude from taxable income scholarships or fellowships that are provided on the basis of scholastic merit or financial need by government entities or other exempt organizations and that are for study at an educational organization which has a regular faculty and curriculum. Amounts representing compensation for services performed in the past, or which are paid on the condition that the recipient render present or future services, would not be excludable.

We agree that the problem of distinguishing compensatory payments from excludable amounts is a principal source of controversy under existing section 117. We also agree that the "primary purpose" test of the existing regulations, upheld in Bingler v. Johnson, 394 U.S. 741 (1969), has not eliminated controversy in this area. However, we do not believe your proposal would significantly reduce the existing level of controversy. "Compensatory" payments would continue to be included in income, even though they satisfy all other conditions for exclusion, but the proposal does not spell out what grants are "compensatory." It has always been easier to state that compensatory payments should be taxable than to articulate a rule that draws an understandable, easily enforceable line between compensatory and noncompensatory arrangements. This has proven to be a vexing issue, for example, with respect to research grants where the grantor may benefit from the research, and in cases of grants to degree candidates where all participants in a particular program are required to perform services. Although it could be a harsh result to include the entire amount of any "scholarship" payment in income as a result of some service performed in this situation, allocating an appropriate portion of the "grant" as taxable compensation could be extremely difficult. A related equally difficult area not specifically considered in the Draft Report is the widespread use of arrangements under which employers provide "scholarships" for dependents of their employees, apparently as compensation to the employees. We recognize that it may not be possible to articulate a statutory test that will be entirely satisfactory but we do think that further efforts towards that goal could be useful.

The Draft Report's proposal does impose a number of "bright line" limitations on the types of payments that would qualify for exclusion. While such limitations would clearly prevent some persons from claiming the exclusion and might thereby reduce the volume of controversy, the particular limitations proposed do not appear to be based on the particular findings in the Draft Report and we believe that standing alone they would not significantly reduce the difficulties in this area. For example, the basis for the proposals to limit the exclusion to grants for study at exempt educational institutions which have a regular faculty and curriculum, and to deny an exclusion for any amount covering travel is not clear. These provisions would bias the exclusion against those whose educational endeavors entail study at libraries, churches, or other institutions unaffiliated with facultied educational organizations. They would also bias the exclusion against those whose educational endeavors entail travel (including, for example, recipients of Fulbright Fellowships). Yet the Draft Report does not indicate that scholarships for study at such institutions or payments for travel as distinct from meals, lodging, or other personal expenses, have generated an unusual degree of controversy under section 117.

We also do not understand the reason for limiting excludable scholarships and fellowships to those offered by government entities or exempt organizations. There are taxable entities that do provide non-compensatory scholarship funds on the basis of merit, need or other objective criteria. Conversely, the need to determine whether a "scholarship" in fact represents payment for services rendered is as prevalent where the grantor is exempt or a governmental entity as where it is not. Denying an exclusion for grants from nonexempt, nongovernmental grantors would thus not seem significantly to alleviate the problem of identifying grants that represent compensation for services, and it is not clear to us what other policy this limitation serves.

The requirement of your proposal that a scholarship or fellowship be based on financial need or scholastic achievement may be helpful in limiting the exclusion to non-compensatory payments. However, as now drafted, the language of this proposal could be construed to disqualify a grant based on leadership or similar non-"scholastic" achievements, and grants directed to a limited group of recipients such as those from a particular geographic location or from a disadvantaged minority group. There is no apparent reason advanced in the Draft Report for denying an exclusion to this type of grant.

We believe the Report might well examine alternatives to the single legislative approach it suggests. For example, a thorough review of the tax treatment of scholarships might explore whether, in view of the persistence of controversy both before and since 1954, an exclusion of this nature is actually worth the cost. In particular, the Report might consider the advantages and drawbacks of other possible revisions to section 117, including the following:

1. Limiting Section 117 to Tuition and Fees - One approach might be to limit the section 117 exclusion to amounts received for tuition, fees, and other direct expenses of education such as books and supplies, but not to include amounts received for meals, lodging, or other personal expenses. The impact of this approach on most scholarship recipients could be negligible or nonexistent. For example, under the current tax provisions, a single individual with no outside income who received a $6,000 scholarship, $3,000 of which went to pay for tuition, fees and books, would incur no tax on the $3,000 balance required to be included in income.

Much of the litigation under section 117 has involved the proper characterization of amounts received other than for tuition and fees, and we would expect a substantial reduction in controversy under such a provision. However, limiting the exclusion to tuition and fees would not eliminate difficulties in all cases since it would still be necessary to determine whether some part of a grant, even for tuition and fees only, was attributable to the performance of services. In addition, this approach would admittedly curtail the exclusion for room, board, and travel grants that have long been recognized as excludable scholarships under existing law.

2. Limiting Section 117 to Degree Candidates - A second possible approach might be to limit the exclusion under section 117 to amounts received for tuition, fees and living expenses of candidates for degrees. This approach would continue to permit the exclusion of amounts received as research and travel grants by individuals pursuing advanced degrees and to that extent the opportunity for attempts to structure compensation as an excludable scholarship would remain. However, eliminating the exclusion for non-degree candidates would eliminate a large percentage of controversial cases, according to the findings of the Draft Report. This approach is similar to existing law in the United Kingdom.

3. Restricting Scholarships or Fellowships as to Total Amounts Excludable - A limit similar to the limit now in effect for non-degree candidates could be placed on the maximum excludable amount for all payments. While this approach would not solve the problems of identifying compensatory payments, it would limit the amounts in controversy and reduce the potential cost to the Treasury of improper exclusions.

Each of the above approaches, whether considered alone or in connection with others, has potential advantages and drawbacks. If the goal is, as your Draft Report suggests, to eliminate the controversy over "compensatory" payments, it may be that quite specific legislative language, or at least quite specific legislative history, would be required, enumerating the types of payments that are deemed compensatory. In the last analysis, absent fairly rough "bright line" tests, this question may always turn on specific facts and circumstances and generate a corresponding amount of controversy.

II. Section 162 Deduction for Educational Expenses

The Draft Report concludes that the distinction under existing regulations between expenses for education "required" by a taxpayer's employer or necessary to maintain skills (deductible) and expenses for education undertaken to qualify a taxpayer for a new job (nondeductible) is a source of controversy and is difficult to administer. In this connection, the Draft Report also observes:

> "While the 1967 regulations make a sharp distinction between costs incurred to 'maintain' earning capacity (deductible) and costs incurred to create new earning capability (nondeductible), they do not make a distinction for tax purposes between expenses of education as preparation for living (personal) and expenses of education as preparation for earning (capital). The result is to treat job-related educational expenses for courses of study which go beyond the maintenance of basic minimum skills in the same manner as personal outlays. Neither kind of educational expense is deductible."

The Draft Report thus recognizes, but does not explore in detail, the fact that tax treatment of educational expenses involves two related issues. The first is the extent to which tax recovery ought to be allowed for particular educational expenses. The second is whether, if recovery is to be allowed, it ought to be deductible against current income or capitalized and amortized through deductions against future income over a period of time. The latter approach could raise difficult administrative problems.

The Draft Report's proposed legislation would permit a current deduction for certain educational expenses that are paid or incurred "in connection with" the trade or business of the taxpayer. We do not believe this language would eliminate the principal complaint you have raised about the existing regulations--namely, the difficulty of determining the appropriate relationship of the deductible expense to a trade or business. At some points, the Draft Report suggests that the intended interpretation was to permit a deduction against current income for any potentially business-related education expenses incurred by a person who already has a trade or business, without regard to whether that education is directly related to his existing business or is intended to qualify him for a potential new business. (Draft Report p. 88.)

A narrower interpretation of your proposed language might be that a deduction would be permitted for expenses that bear some relationship to the taxpayer's current trade or business even though they increase the taxpayer's earning power and under current law are nondeductible. The Draft Report suggests that something of this nature was intended when it refers to expenses "related to the taxpayer's employment." (Draft Report p. 89.)

Neither interpretation would, in our view, substantially diminish the level of controversy in this area. Under the narrower approach, the Service would face significant problems in determining what kinds of courses bore what relationship to which jobs. It would also be necessary to fashion a rule to determine whether individuals who went on leave from regular employment in order to further their education on a full-time basis were "engaged in" a trade or business. While these issues are present under current law, the proposed broadening of current rules could increase the extent to which such issues arise.

Furthermore, whether its language is read broadly or narrowly, the Draft Report clearly does not propose to permit any deduction for expenses of education that is purely recreational or personal in nature. Under existing law, neither personal educational expenses nor "capital" educational expenses to increase earning power or qualify for a new job are deductible. Accordingly, it is not now necessary to distinguish "personal" from potentially "business connected" education. Under the approach of the Draft Report, the Service would have to distinguish "personal" education expenses from "business connected", educational expenses which are capital in nature. This would be extremely difficult and would itself undoubtedly lead to a substantial amount of controversy.* If this approach is to be considered at all we believe it would have to be accompanied by some fairly "bright line" tests.

Finally, though the Draft Report expresses some concern about the equity of existing law, its proposal would continue to place at a tax disadvantage by far the majority of students who pursue their education on a full-time basis before they enter the job market at all. The education of such individuals would continue to be financed with after-tax dollars.

A solution to these difficulties proposed by some would be to permit some educational expenditures that under current law are not deductible to be capitalized and recovered over a subsequent period of earnings. Even though such an approach may have theoretical appeal, there would be difficulties in implementing such a proposal. For example, it would be necessary to fashion rules to determine on an equitable basis the proper period over which expenses would be amortized, the amortizable amounts applicable to separate educational expenses, and the treatment of unamortized expenses when the employee terminated employment. It would also be necessary to determine whether educational expenses should be deductible against unearned, passive income and to what extent they should be deductible against income earned in a trade or business other than the one to which the education relates.

As it is, we are not sure that the proposal actually advocated by the Draft Report takes adequate account of the issues. If interpreted broadly to permit the deduction of potentially income-generating educational expenses by any employed individual, this would lead to widespread current deductibility of essentially capital expenditures and would also treat unfairly those who attended school full time before entering the job market. If taken more narrowly to apply to expenses somehow related to a taxpayer's current employment, it would still permit current deductions for capital expenditures, would create serious interpretive problems and would still favor, for tax purposes, the class of individuals already in the job market.

---

*Almost any educational expense could in some arguable way enhance earning potential. For example, any college student might assert that a B.A. itself enhances earning potential without regard to the course of study. A professional scientist who is a part-time, non-degree candidate literature student could argue that his studies increased his language skills and would be useful in his publications.

101

Consequently, before final publication, we think it would be essential to give further consideration to the proposed revision of the current rules on deductibility of educational expenses both to clarify the nature of the proposal and to consider in greater depth the ramifications of any significant expansion of the current rules.

We hope that these comments may be of some assistance. If you have any further questions, please feel free to contact us.

Sincerely,

Donald C. Lubick
Donald C. Lubick
Assistant Secretary (Tax Policy)

Jerome Kurtz
Jerome Kurtz
Commissioner of Internal Revenue

INTERNAL REVENUE SERVICE--

ADMINISTRATIVE APPEALS PROCEDURE

An examining revenue agent, on completing his audit of a return, can either recommend that the return be accepted as filed or that an adjustment be made. A proposed adjustment may be in favor either of the Government or of the taxpayer. If the proposed adjustment is in favor of the Government and the taxpayer wishes to contest the proposed deficiency, he has a choice of three alternative settlement procedures:

1. The taxpayer may request a conference at the District Conference level. If a settlement is not reached at the District level, the taxpayer still has the option of proceeding directly to trial or of taking his case to the next administrative settlement stage at the Appellate Division level.

2. The taxpayer may file a protest and request a conference at the Appellate Division level. A case becomes a nondocketed receipt on the records of the Appellate Division when the protest is filed. If a settlement is not reached at the Appellate level, the taxpayer still has the option of proceeding directly to court.

3. The taxpayer may entirely by-pass the administrative settlement process at both the District and the Appellate Division levels by:

(a) Paying the amount of the proposed deficiency either with or without executing a form 870 (waiver of restrictions on assessment and collection of deficiency in tax and acceptance of overassessment), and then filing suit for refund in the District Court or the Court of Claims. If this procedure is followed, the case becomes a docketed receipt on the records of the Department of Justice and is assigned to a docket attorney in the Office of Chief Counsel. The attorney will examine the file and prepare a written recommendation of settlement or trial to the Department of Justice.

(b) Taking no action on receipt of either a 30-day notice of proposed deficiency or a 90-day statutory notice of deficiency, paying the amount of the proposed deficiency and then filing a suit for refund in the District Court or the Court of Claims.

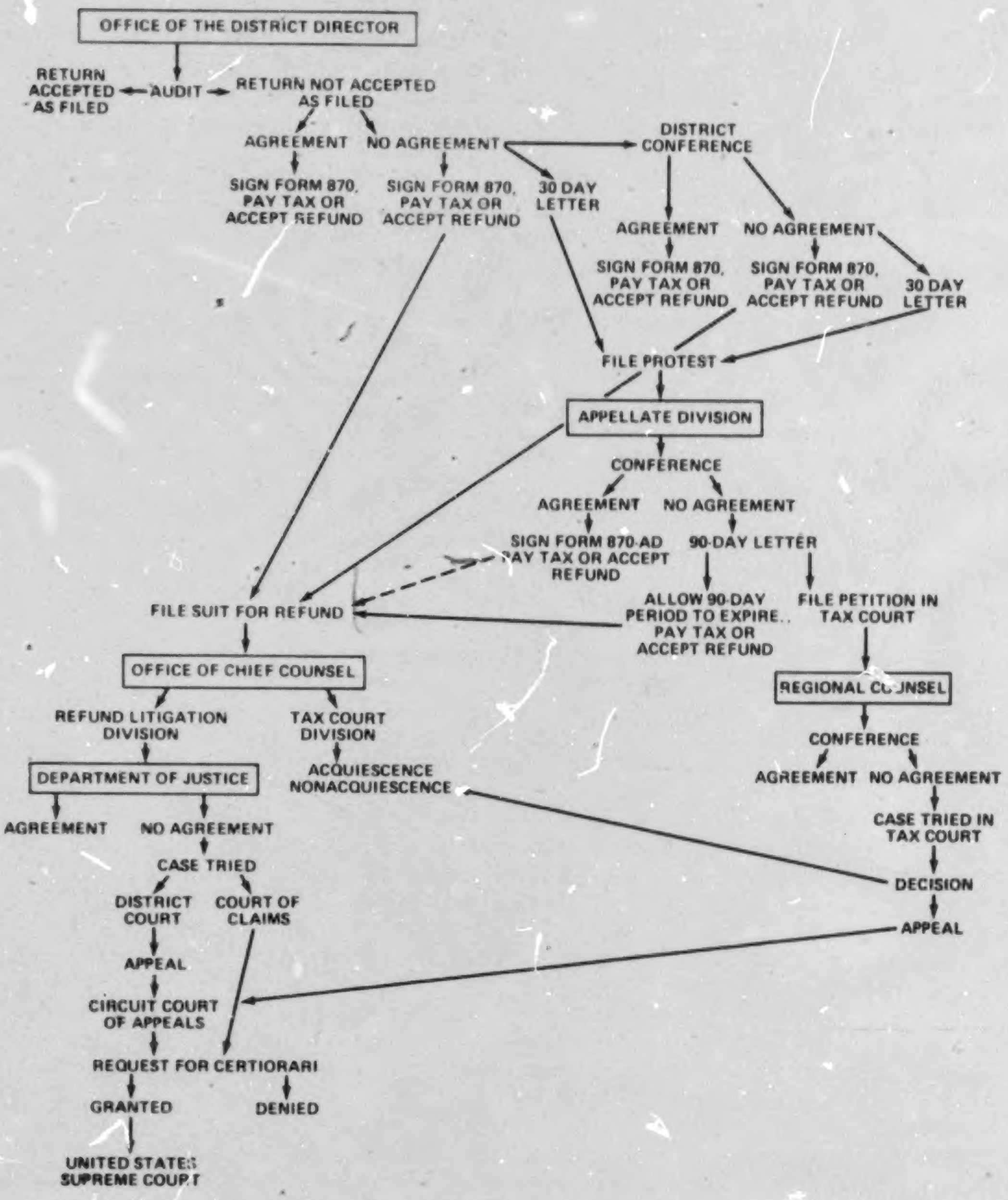
(c) Filing a petition in the Tax Court directly upon receipt of a statutory notice of deficiency issued either by the District Director or by the Appellate Division. The case is recorded as a docketed receipt on the records of the Appellate Division at this stage.

The chart on page 93 outlines the procedures applicable to the settlement and trial of tax controversies, beginning at the level of audit and ending, infrequently, with final determination by the United States Supreme Court.

Most controversies which arise out of deficiencies based on section 117 or regulations section 1.162-5 adjustments, and which proceed to the docketed stage, follow the deficiency settlement route, not the refund settlement route. The deficiency settlement route, which may end in the filing of a petition in the Tax Court, allows the Government to raise, for the first time in an answer and counterclaim, issues not raised during the settlement procedure, but arising out of the tax return(s) filed for the year(s) in issue. These unrelated issues may be the basis for a further deficiency assessment and money judgment against the taxpayer. Likewise, in a deficiency procedure, the taxpayer may resist the deficiency in the Tax Court on any ground he wishes, without regard to whether he argued this position during settlement negotiations at the District or Appellate Division levels. A refund claim, on the other hand, sets in motion administrative procedures which allow the Government to consider (1) issues raised by the refund claim and (2) related issues raised by returns filed in years not covered by the claim. However, neither the taxpayer nor the Government can raise for the first time in the complaint or counterclaim issues not raised in the refund claim.

These differences between the deficiency settlement and refund settlement procedures have a bearing on the classification of cases by issue in accordance with the Uniform Issue List. Nondocketed cases reported by the District Director's office are classified by principal issue in controversy and therefore are listed only once. Both nondocketed and docketed cases received and reported by the Appellate Division are classified by principal issues in controversy and therefore are listed only once. Docketed cases (that is, refund claims and Tax Court petitions) received and reported by the Office of Chief Counsel and all cases closed by an opinion are classified under each issue raised in the proceeding and therefore may be listed more than one time. All docketed and decided cases listed under section 117 or regulations section 1.162-5 are counted one time only even though they may be listed under separate issue categories more than one time.

ADMINISTRATIVE APPEALS PROCEDURE



INCREASE IN CONTESTED TAX DEFICIENCIES

During the last several years there has been a significant increase in the number of taxpayers contesting tax deficiencies determined by IRS. There has been an increase also in the number of refund claims filed and denied. This growth in the level of tax controversy has occurred at all stages of the administrative and judicial process. The growth is reflected in a sharp increase, since 1974, in the number of contested cases received at the IRS District Conference level. 1/ (See p. 95.) See appendix II for a summary of the Internal Revenue Service administrative appeals procedure for the resolution of tax controversies.

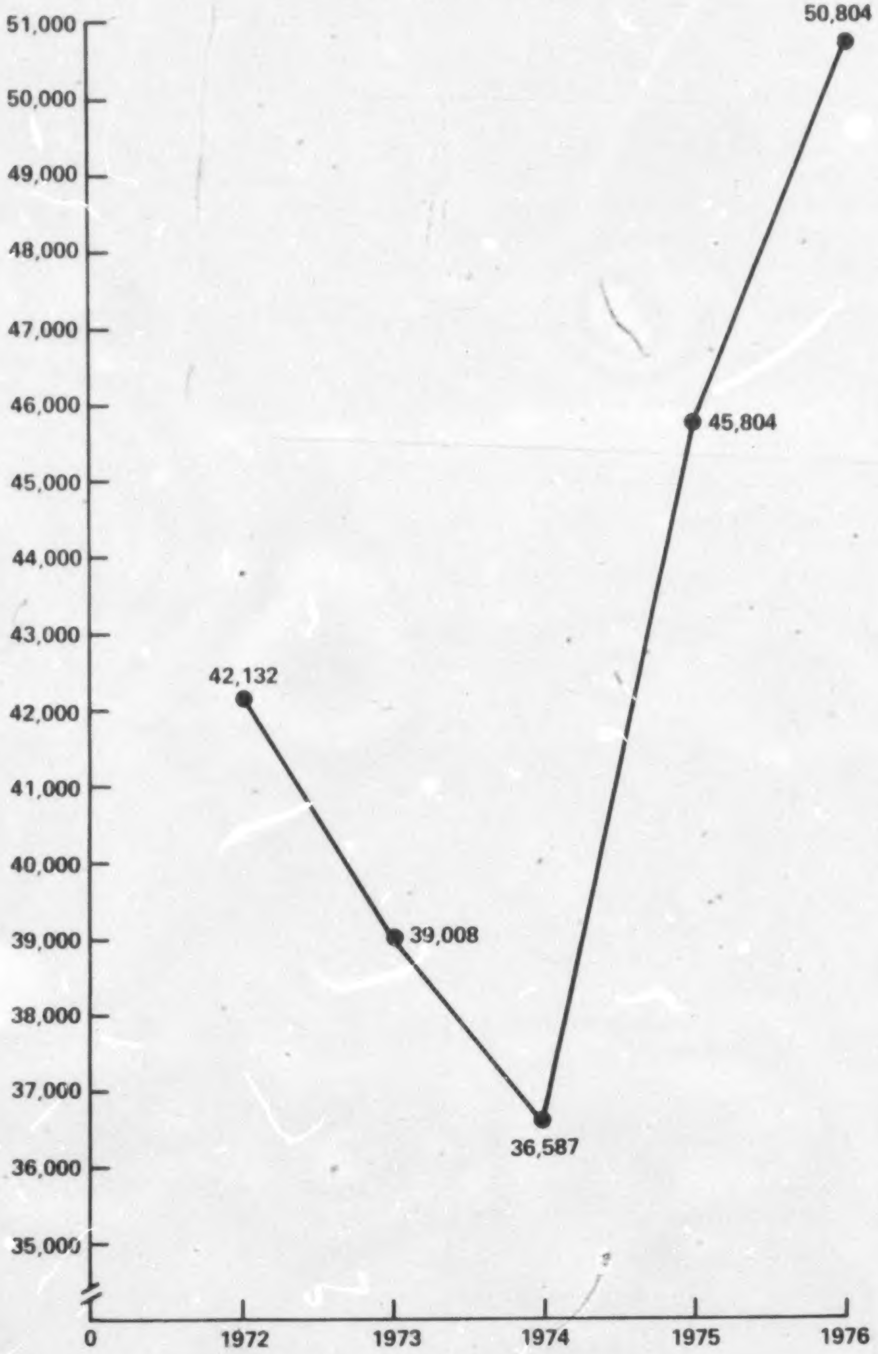
After a period of decline, the number of unagreed case disposals at the District Conference level began, in fiscal year 1975, to increase. It was 14,055 in 1972, dropped to 10,951 in 1975, and went up to 13,228 in 1976. As a result, the number of nondocketed cases received by the Appellate Division began to rise in fiscal year 1975. (See p. 96.)

The increase in the number of contested deficiencies at the District level is reflected also in a sharp increase, since 1974, in the receipt of docketed cases by the Appellate Division. (See p. 97.)

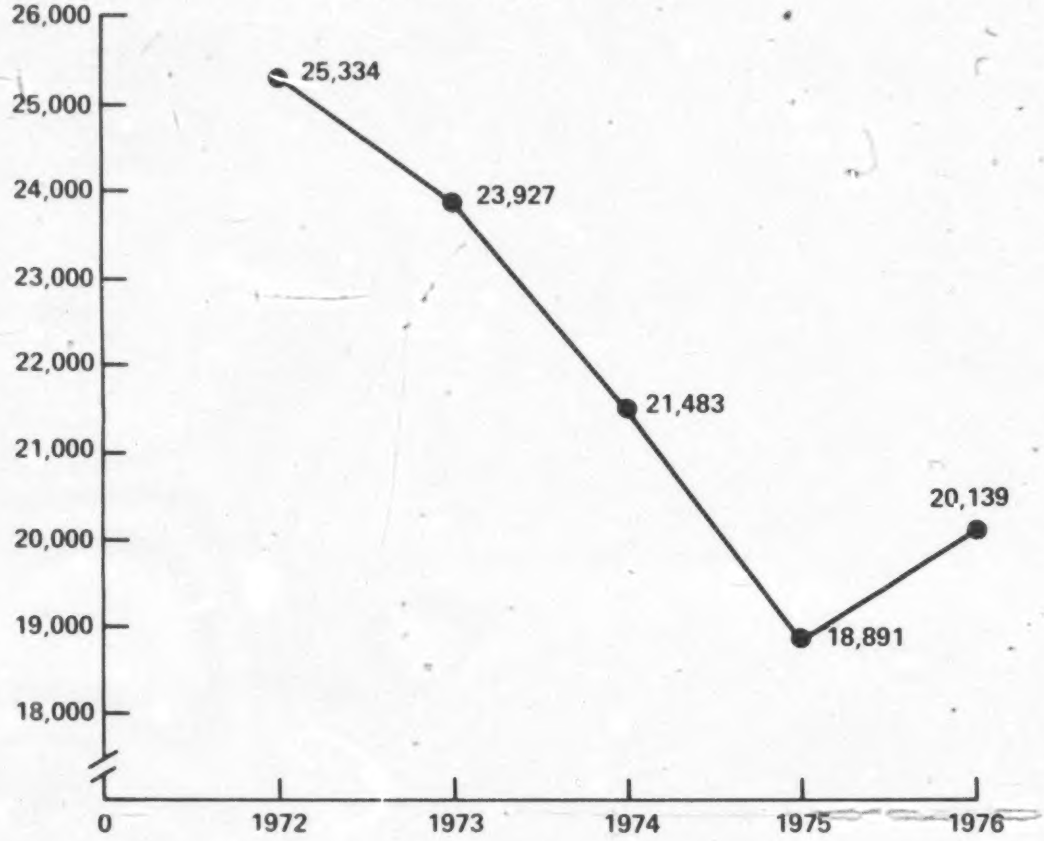
Further, the evidence is that taxpayers as a whole are becoming more litigious. As shown by Table 1.1 below, the Appellate Division has reported a steady increase, during the period fiscal years 1972 through 1976, in the number and percentage of docketed Tax Court case receipts which bypassed the Appellate Conference stage; from 7,590 (73 percent) in fiscal year 1972 to 12,268 (79 percent) in fiscal year 1976.

1/During this same period FY 1974-FY 1976, there was an increase in the total number of returns examined, but this increase was approximately one-half as much as the increase in the receipt of nondocketed cases at the District Conference level. See Annual Report of the Commissioner of Internal Revenue FY 1976, p. 25.

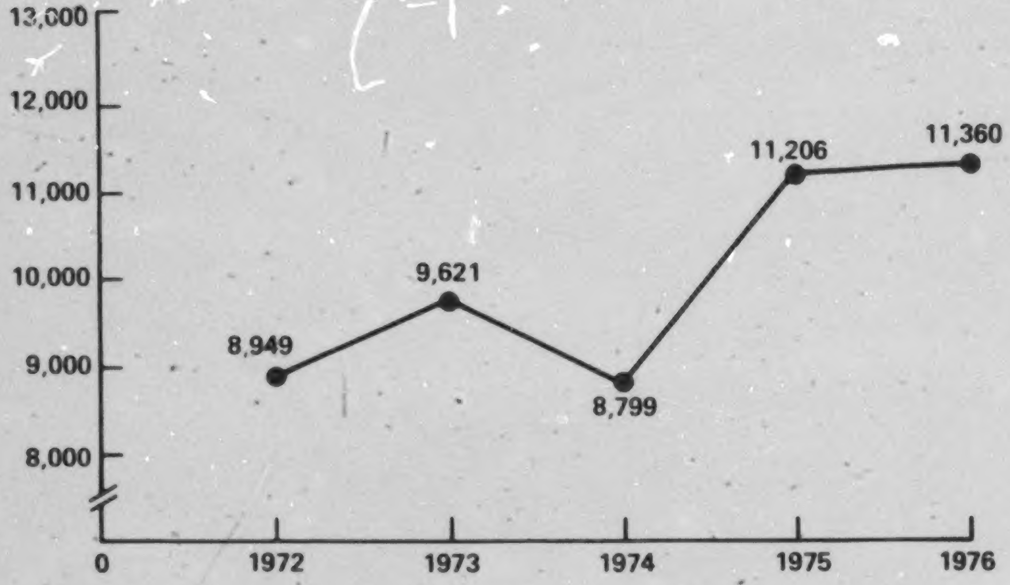
TREND IN RECEIPT OF NONDOCKETED CASES AT DISTRICT CONFERENCE LEVEL FY 1972 - FY 1976



TRENDIN RECEIPT OF NONDOCKETED CASES BY APPELLATE DIVISION FY 1972 - FY 1976



TREND IN RECEIPT OF DOCKETED CASES BY APPELLATE DIVISION FY 1972 - FY 1976



109

Table 1.1
Number and Percent of Docketed Tax Court Cases Received Which By-passed the Appellate Conference Stage (note a)

Fiscal year	Number	Percent
1972	7,590	72.92
1973	8,406	74.36
1974	8,713	71.60
1975	11,109	77.90
1976	12,653	76.79
1977	12,268	79.37

a/Even though a taxpayer initially short-circuits the administrative settlement procedure by filing a Tax Court petition before the Appellate Conference stage, his case is likely to be settled without a trial. Of the total docketed receipts which by-pass the Appellete Conference stage, on an average more than 70 percent are disposed of by settlement without trial.

Most docketed cases are settled before trial. Were this not the case, the volume of unagreed cases passed on to the courts for decision would overwhelm the judicial system and create an unmanageable body of case law. Table 1.2 below sets forth the number and percent of docketed work units 1/ disposed of by settlement prior to trial for the 3-year period fiscal years 1974 though 1976.

Table 1.2

Number and Percent of Docketed Work Units Disposed of by Settlement

	FY 1974		FY 1975		FY 1976	
	No.	Percent	No.	Percent	No.	Percent
Tax Court (excluding small tax cases)	3,189	76.57	3,085	71.04	3,123	69.28
Small tax cases	1,765	74.47	1,939	76.19	2,261	74.94
District Court	868	55.07	784	54.97	909	52.04
Court of Claims	146	50.68	103	66.99	92	64.13

1/A work unit is a single case or two or more related cases settled or decided together.

The settlement record for docketed cases in the Tax Court, involving proposed deficiencies of less than $5,000 is less favorable to the Government than to taxpayers. 1/ In contrast, the record of cases closed by decision in the under $5,000 category is more favorable to the Government. Table 1.3 below summarizes the closed case record for docketed Tax Court cases in the group dollar size of less than $5,000 for fiscal years 1975 through 1977. Comparable data is not available for refund cases filed in the District Courts or the Court of Claims.

Table 1.3

Number Of Work Units In The Group Dollar Size Of Less Than $5,000, And Percent Closed In Favor Of The Government (note a)

	FY 1975		FY 1976		FY 1977	
	No.	Percent	No.	Percent	No.	Percent
Docketed cases closed by settlement						
$ 0 - 1,500	2,350	44.5	2,769	46.6	3,029	46.4
1,500 - 5,000	671	46.0	683	47.5	892	46.5
Docketed cases closed by decision (note b)						
$ 0 - 1,500	408	79.4	524	80.3	545	78.1
1,500 - 5,000	86	81.7	107	80.2	135	77.4

a/The group dollar size figure refers to the dollar size of the case, not to the dollar size of the work unit.

b/Not all cases closed by formal judgment of a court are accompanied by a written opinion setting forth the legal reasoning and principles of law relied upon. In general, the small tax cases are closed by decision without published opinion.

The record of cases closed by opinion for all group dollar sizes is less favorable to the Government than for cases closed by decision in the group dollar size of less than $5,000. (See table 1.4.)

1/The settlement record for cases in the group dollar size of $5,000 and more are not relevant here, since the educational tax cases do not generate proposed tax deficiencies in excess of $5,000.

Table 1.4

Number and Percent of Opinions Rendered in Favor of the Government

Court	FY 1974		FY 1975		FY 1976	
	No.	Percent	No.	Percent	No.	Percent
Tax Court (excluding small tax cases)	234	51.4	255	54.7	294	52.9
Small tax cases	170	54.5	192	61.7	265	62.6

Despite a settlement record for the under $5,000 tax cases which tends to favor taxpayers and a trial record in the Tax Court which shows a preponderance of Government wins, there has been no reduction in the volume of litigation, especially in the small tax cases procedure of the Tax Court. Table 1.5 below sets forth the data with respect to number of opinions in tax cases in the Tax Court tried through to a final decision on the merits for fiscal years 1974 through 1976.

Table 1.5

Number of Opinions Rendered in Tax Cases Tried Through to a Final Decision on the merits

Court	FY 1974	FY 1975	FY 1976
Tax Court (excluding small tax cases)	455	466	556
Small tax cases	312	311	423

METHOD USED TO CALCULATE A DEFICIENCY BASED UPON DISALLOWANCE OF AN INCOME EXCLUSION OR ITEMIZED DEDUCTION

The increase in tax revenue generated by disallowance of an income exclusion or deduction is determined by the dollar size of the exclusion or deduction and by the interaction of the particular exclusion or deduction provision with related tax computation rules. Since the nominal rate structure is progressive and differs depending upon the filing status of the taxpayer, the tax value of an income exclusion or deduction depends also on the income level and filing status of taxpayers who claim the exclusion or deduction.

OFFSETS AGAINST GROSS INCOME TO REACH ADJUSTED GROSS INCOME

The dollar amount of a deficiency generated by disallowance of an exclusion from gross income (section 61) or by disallowance of a business expense deduction from gross income to reach adjusted gross income (section 162) is a function of three variables: (1) the dollar amount of the exclusion or deduction, (2) the change in allowable deduction whose amount is related to the size of the adjusted gross income base, and (3) the applicable average marginal tax rate. 1/

In the simplest case where the larger of the standard deduction or low income allowance is elected, the amount of deficiency generated by an income exclusion or business expense deduction is a function only of the amount of the exclusion, the amount of the applicable standard deduction (or low income allowance), and the average marginal tax

---

1/It is related also to those tax credits whose dollar amount is determined by the size of the income base or which may be wasted because the net taxable income level is too low to generate tax liability before credits. In the sample of returns of taxpayers contesting deficiencies at the Appellate Division level there were no returns claiming a tax credit. Hence, in order to keep this explanation as simple as possible, the effect of tax credits on the tax value of an income exclusion or deduction is disregarded.

rate. 1/ This latter simple relationship can be expressed by a series of equations as follows:

$$\mathrm{Def} = T_1 - T_o$$

$$T_o = (GI - EI - D_s)tx_o$$

$$T_1 = (GI - D)tx_1$$

Where

Def = Dollar amount of deficiency proposed

T_o = Tax liability shown on return as filed

T_1 = Tax liability after disallowance of exclusion

GI = Gross income received

EI = Income excluded from the gross income base

D = Either D_s or D_i, depending on which deduction results in a lower tax

---

1/An exclusion from gross income or deduction from gross income to reach adjusted gross income affects the size of the allowable standard deduction in those cases where the offset reduces the adjusted gross income base to less than the applicable maximum dollar amount. That is, a proposed deficiency based upon disallowance of an income exclusion or business expense deduction reflects the increase in tax attributable to the addition to the adjusted gross income base reduced by the decrease in tax attributable to the larger standard deduction.

$$D_s = .16(GI - EI - D_b) \begin{array}{lll} \leq \$\,2{,}800 & \text{(married, filing jointly)} & \geq \$\,2{,}100 \\ \leq 2{,}400 & \text{(single return))} & \geq 1{,}700 \\ \leq 1{,}400 & \text{(married, filing separately)} & \geq 1{,}050 \end{array}$$

Where D_b = business expense deductions

For tax years beginning 1977 the standard deduction and low income allowance are replaced by the zero bracket amount. This change simplifies the calculation of net taxable income but does not change the basic interrelationship between the deduction rules and the zero bracket amount (i.e., standard deduction).

D_s = Standard deduction or low income allowance

D_i = Itemized deductions

tx_o = Average tax rate applicable to net taxable income reported on return as filed

tx_1 = Average tax rate applicable to net taxable income after adjustment [1]

If the taxpayer elects to itemize his personal deductions, the amount of deficiency generated by disallowance of an income exclusion or business expense deduction may be increased further by a reduction of the allowable medical expense deduction and for the charitable contributions and retirement savings deductions. The change in the adjusted gross income base would be reflected in an increase in the allowable deduction for State income taxes in a subsequent year when (and if) the State income tax deficiency based upon the Federal adjustment is paid. Thus,

$$T_o = (GI - EI) - (n + m + t + c + 1 + rs)tx_o$$

n = Interest on personal indebtedness

m = Medical expense deduction, which is the amount expended M in excess of 3 percent adjusted gross income (AGI).

$$m = M - .03AGI$$

---

[1] Under a progressive income tax system tx_1 is greater than unless the dollar amount of the income excluded is so small that disallowance of the exclusion does not place the taxpayer in a higher marginal tax bracket. The average marginal tax rate M applicable to a deficiency based upon disallowance of an income exclusion is the ratio of the dollar amount of the deficiency to the dollar amount of the exclusion.

$$M_r - Def/EI$$

The amount of the deficiency attributable solely to disallowance of the income exclusion is

$$EI(tx_1).$$

The dollar amount of the deficiency attributable to the fact that the addition of EI to the tax base may place the remainder of net taxable income in a higher average marginal tax rate bracket is (GI-EI-D) $(tx_1 - tx_o)$. The deficiency generated by the addition of EI to the tax base is the sum of these two amounts.

$$Def = EI(tx_1) + (GI - EI - D)(tx_1 - tx_o)$$

c = Charitable contributions C deduction subject in most cases to the maximum limitation of 50 percent of adjusted gross income..

$$c = C \leq .50AGI$$

l = Casualty loss L deduction in excess of \$100

$$l = L - \$100$$

rs = Retirement savings deduction which is subject to the maximum limitation of the lesser of \$1,500 or 15 percent of taxable wages W.

$$rs = \$\,1{,}500 \leq .15W$$

FTI = Federal taxable income

$t = t_i + t_s$ = Deduction for State nonbusiness income taxes t_i and nonbusiness excise and property taxes t_s; if subscript followed by a "o" it is tax paid with return; if by a "1" it is tax paid after Federal adjustment.

$$t_{i_1} = \%\,(FTI) + t_{io}$$

OFFSETS AGAINST ADJUSTED GROSS INCOME TO REACH NET TAXABLE INCOME

The dollar amount of a tax deficiency generated by disallowance of an itemized deduction, as for educational expenses claimed as a miscellaneous expense, is the amount of the deduction disallowed, reduced, where appropriate by the standard deduction (low income allowance), times the applicable average marginal tax rate. 1/ The itemized deduction disallowed must be reduced by the standard deduction (low income allowance) if the sum of the remaining allowable itemized deductions is less than the greater of 16 percent of adjusted gross income or the maximum dollar

---

1/Number of returns using D_s when education expenses are disallowed.

limit. In the simplest case where the sum of the remaining allowable itemized deduction is zero

$$Def = (D_i - D_s)tx_1 + (GI \pm EI)(tx_1 - tx_0).$$

The dollar amount of the tax deficiencies computed for each of the three educational tax issues reflect the interrelationships among the income exclusion, personal deduction, and related tax computational rules which applied to each taxpayer included in the sample of Appellate Division cases.

(268044)

Single copies of GAO reports are available free of charge. Requests (except by Members of Congress) for additional quantities should be accompanied by payment of $1.00 per copy.

Requests for single copies (without charge) should be sent to:

U.S. General Accounting Office
Distribution Section, Room 1518
441 G Street, NW.
Washington, DC 20548

Requests for multiple copies should be sent with checks or money orders to:

U.S. General Accounting Office
Distribution Section
P.O. Box 1020
Washington, DC 20013

Checks or money orders should be made payable to the U.S. General Accounting Office. NOTE: Stamps or Superintendent of Documents coupons will not be accepted.

PLEASE DO NOT SEND CASH

To expedite filling your order, use the report number and date in the lower right corner of the front cover.

GAO reports are now available on microfiche. If such copies will meet your needs, be sure to specify that you want microfiche copies.